No. 74-799

Supreme Court, U. S.
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In the Supreme Court of the United States

OCTOBER TERM, 1974

UNITED STATES OF AMERICA, PETITIONER

v.

FOSTER LUMBER COMPANY, INC.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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INDEX

	Page
Opinions below	1
Jurisdiction	2
Question presented	2
Statement	3
Reasons for granting the writ	6
Conclusion	12
Appendix A	1a
Appendix B	8a
Appendix C	15a
Appendix D	17a

CITATIONS

Cases:

Axelrod v. *Commissioner*, No. 74-1511, decided December 17, 1974, reversing 32 T.C.M. 885 (decided August 28, 1973)	6
Chartier Real Estate Co. v. *Commissioner*, 52 T.C. 346, affirmed *per curiam*, 428 F. 2d 474	6, 10
Continental Equities, Inc. v. *Commissioner*, 33 T.C.M. 812 (decided September 25, 1974)	7
Data Products Corp. v. *United States*, (decided September 25, 1974)	7, 11
Mutual Assurance Society of Virginia Corp. v. *Commissioner*, C.A. 4, No. 74-1133, decided October 18, 1974	6, 8, 10

Cases—Continued

	Page
Naegele v. *United States*, decided August 6, 1973 (D. Minn.), pending, No. 73-1921 (C.A. 8)	6-7
Olympic Foundry Co. v. *United States*, 493 F. 2d 1247	6
Weil v. *Commissioner*, 23 T.C. affirmed, 229 F. 2d 593	

Statutes:

Internal Revenue Code of 1954 (26 U.S.C.):	
Secs. 1-1564	8
Sec. 3	8
Sec. 4	8
Sec. 11	3, 4, 9
Sec. 56	8
Sec. 61(a)	8
Sec. 63(a)	4, 8, 9, 17a
Sec. 161	8
Sec. 170	8
Sec. 172	2
Sec. 172(a)	17a
Sec. 172(b)	6, 7, 8, 9, 10, 17a
Sec. 172(d)	9, 19a
Sec. 211	8
Sec. 242	9
Sec. 243	9
Sec. 244	9
Sec. 245	9
Sec. 246(b)	9
Sec. 247	9
Sec. 593(b)	9
Sec. 832(a)	9

Statutes—Continued

	Page
Sec. 852(b)	9
Sec. 922	9
Sec. 1201	2, 3, 4, 5, 6
Sec. 1201(a)	4, 9, 10, 20a
Sec. 1202	21a

Miscellaneous:

H. Rep. No. 855, 76th Cong., 1st Sess.	11

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v.

FOSTER LUMBER COMPANY, INC.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

The Solicitor General, on behalf of the United States, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Eighth Circuit in the above-captioned case.

OPINIONS BELOW

The memorandum and order of the district court, and the stipulation of facts to which it refers (Appendix A, *infra*, pp. 1a-7a), are not reported. The opinion of the court of appeals (Appendix B, *infra*, pp. 8a-14a) is reported at 500 F.2d 1230.

JURISDICTION

The judgment of the court of appeals was entered on July 29, 1974 (Appendix C, *infra*, pp. 15a-16a). On October 17, 1974, Mr. Justice Blackmun extended the time for filing a petition for a writ of certiorari to and including December 26, 1974. The jurisdiction of this Court is invoked under 28 U.S.C. 1254 (1).

QUESTION PRESENTED

Section 172 of the Internal Revenue Code of 1954 permits the carryback of a net operating loss to a taxable year prior to the year in which the loss is sustained, and a carryover to a succeeding year of the amount, if any, by which the loss exceeds the taxable income for each prior year to which the loss may be carried.

The question presented is whether, in carrying back a net operating loss to a year in which the taxpayer had both ordinary income and capital gains and employed the alternative tax computation method of Section 1201, the loss deduction available for carryover to a succeeding year is the amount by which the loss exceeds only the ordinary income for the prior year, as the decision below held, or the amount by which the loss exceeds both the ordinary income and capital gains for the prior year.

STATEMENT

Respondent is in the lumber business (Appendix A, *infra*, p. 4a).[1] For its taxable years ended March 31, 1966 through 1968, respondent reported the following amounts of ordinary and capital gains income (Appendix A, *infra*, p. 4a):

Taxable Year	Net Ordinary Income	Excess of Net Long-Term Capital Gain Over Net Short-Term Capital Loss	Total Taxable Income
1966	$ 7,236.05	$166,634.81	$173,870.86
1967	$114,261.82	$114,655.96	$228,917.78
1968	($ 42,203.12)	———	($ 42,203.12)

Because respondent sustained a net operating loss of $42,203.12 for its taxable year 1968, it elected to carryback that loss to 1966, and filed Form 1139 (Corporation Application for Tentative Refund from Carryback of Net Operating Loss). As the Code prescribes, respondent recomputed its 1966 tax liability under the method provided by Section 11 (the so-called "regular method"), and the "alternative tax computation" provided by Section 1201 of the Code. Taking into account the carryback of the 1968 loss of $42,203.12, respondent's computations of its 1966 income tax liability under each of the two methods were as follows (Appendix A, *infra*, pp. 4a-5a):

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[1] The case was submitted to the district court on a stipulation of facts (Appendix A, *infra*, pp. 3a-7a).

"Regular Method" (Section 11)

Taxable Income (excluding net operating loss deduction):		
Ordinary income	$ 7,236.05	
Capital gains income	166,634.81	$173,870.86
LESS: Net operating loss deduction resulting from carryback of 1968 net operating loss		42,203.12
Taxable Income (Section 63(a))		$131,667.74
Regular tax (1966 rates)		$ 58,200.52

"Alternative Method" (Section 1201)

Taxable Income (excluding net operating loss deduction):		
Ordinary income	$ 7,236.05	
Capital gains income	166,634.81	$173,870.86
LESS: Net operating loss deduction resulting from carryback of 1968 net operating loss		42,203.12
Taxable Income (Section 63(a))		131,667.74
(Step 1—Partial Tax)		
LESS: Excess of net long-term capital gain over net short-term capital loss		166,634.81
Balance		($34,967.07)
Partial Tax at Section 11 rates on balance (Section 1201(a)(1))		—0—
(Step 2—Capital Gains Tax)		
PLUS: Capital Gains Tax at flat 25 percent rate on excess of net long-term capital gain over net short-term capital loss (Section 1201(a)(2))		41,658.70
Alternative Tax (1966 rates)		$ 41,658.70

Since the $41,658.70 tax computed under the "alternative method" of Section 1201 was lower than the tax computed under the "regular method" of Section 11, respondent was required to, and did, report the amount of alternative tax computed under the provisions of Section 1201 as its recomputed 1966 tax liability (Appendix B, *infra*, p. 5a).

This suit involves respondent's tax liability for its taxable year ended March 31, 1967. In applying for a tentative refund from the carryback of a net operating loss for that year, respondent claimed that $34,967.07 of its 1968 loss of $42,203.12, which had been carried back to 1966, was available to offset income for 1967. Respondent based its claim on the contention that its 1968 loss had been "used" in 1966 only to the extent of the ordinary income of $7,236.05 for that year (Appendix A, *infra*, p. 6a).

On audit, the Commissioner of Internal Revenue disallowed respondent's claim for refund for its taxable year 1967 (Appendix A, *infra*, p. 7a). The Commissioner's disallowance was premised on the ground that respondent's 1968 net operating loss of $42,203.12 had been entirely "used" to offset its 1966 taxable income of $173,870.86 for that year. As a result, the Commissioner determined that no part of the 1968 net operating loss deduction was available to respondent to carry forward from its taxable year 1966 to 1967.

The district court upheld respondent's claim for refund (Appendix A, *infra*, pp. 1a-3a) and the court of appeals affirmed (Appendix B, *infra*, pp. 8a-14a).

REASONS FOR GRANTING THE WRIT

1. The decision below directly conflicts with *Mutual Assurance Society of Virginia Corp.* v. *Commissioner*, C.A. 4, No. 74-1133, decided October 18, 1974. In that case, the Fourth Circuit recognized the conflict and explicitly rejected the reasoning of the court below. It held, on parallel facts, that a corporation which carries back a net operating loss to a year in which it employs the alternative tax computation of Section 1201, may carry forward to succeeding years only the excess of such loss over the prior year's ordinary income *and* capital gains. In concluding that the amount of the loss carryback available to offset income of succeeding years is the excess of the loss over only the prior year's ordinary income, the court of appeals misconstrued the plain terms of Section 172(b)(2) of the Code.

The issue has been and continues to be widely litigated [2] and resolution of the conflict by this Court

[2] The First and Ninth Circuits are in accord with the decision below. See *Chartier Real Estate Co.* v. *Commissioner*, 52 T.C. 346, 356-358, affirmed *per curiam*, 428 F.2d 474 (C.A. 1), and *Olympic Foundry Co.* v. *United States*, 493 F.2d 1247 (C.A. 9), affirming *per curiam* an unreported order of February 9, 1972 (W.D. Wash.). The Tax Court's opinion in *Chartier Real Estate Co.* was the first decision on the question and contains the most detailed statement in support of the court below. In *Axelrod* v. *Commissioner*, No. 74-1511, decided December 17, 1974, reversing 32 T.C.M. 885 (decided August 28, 1973), which involved an individual taxpayer, the Sixth Circuit expressed agreement with the *Mutual Assurance Society* decision of the Fourth Circuit.

These decisions have been followed in *Naegele* v. *United States* (decided August 6, 1973) (D. Minn.), now pending before the Eighth Circuit, No. 73-1921, both of which have been appealed by the government; *Continental Equities, Inc.* v. *Commissioner*, 33 T.C.M. 812 (decided July 25, 1974), and *Data Products Corp.* v. *United States* (decided September 25, 1974) (C.D. Cal.).

is essential in order that there be a uniform national rule.

2. Section 172(b)(1) of the Code, Appendix D, *infra*, pp. 17a-18a, permits a taxpayer to carry back a net operating loss deduction to each of the three taxable years preceding the taxable year in which the loss was sustained. Under the procedure prescribed by Section 172(b)(2), Appendix D, *infra*, p. 18a, the loss is first carried back to the earliest of the three taxable years prior to the year of the loss. For present purposes, to the extent the loss is not fully "used" in the earliest of the prior years, Section 172(b)(2) provides for a carryover of the loss to each of the next succeeding two years. The language of Section 172(b)(2), which is central to the question presented in this case, states as follows:

> The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. * * *

Thus, the amount of the net operating loss which may be carried over to succeeding years is the excess of the amount of the loss over the taxpayer's "taxable income" for the earliest year to which the loss is carried back.

As the Fourth Circuit pointed out in *Mutual Assurance Society*, the holding of the court below that respondent's 1968 loss carryback was "used" only to the extent of its 1966 ordinary income, misconstrued the statutory term "taxable income" as it is employed in Section 172(b)(2). That term is defined by Section 63(a) of the Code, Appendix D, *infra*, p. 17a, as gross income less allowable deductions. Under this definition, which is applicable to Section 172(b)(2),[3] "taxable income" would include "all income from whatever source derived" (see Section 61(a)), and would include both ordinary income and capital gains.

Since respondent's 1968 loss of $42,203.12 was less than its 1966 taxable income of $173,870.86, there was no "excess" of the loss over taxable income to be carried over to 1967. The court of appeals' restriction of "taxable income" to include only ordinary income flatly contradicts the definition of that term in Section 63(a).[4]

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[3] The specific language of Section 63(a) applies its definition of "taxable income" to all sections of the Internal Revenue Code contained in Subtitle A, which includes the provisions from Sections 1 to and including 1564.

[4] That the Section 63(a) definition is applicable to Section 172(b)(2) is further demonstrated by the use of the term "taxable income" in many other Code provisions. See *e.g.*, Sections 3, 4, 56, 161, 170 and 211. Indeed, when the term "taxable income" is intended to depart from the Section 63(a) definition, the particular provision includes an explicit

The fact that respondent employed the alternative tax computation under Section 1201(a) does not call for a different result. Section 11 of the Code imposes a "regular" tax on the taxable income of a corporation consisting of the sum of a normal tax equal to 22 percent of the taxable income and a surtax equal to 26 percent of the taxable income exceeding $25,000. However, where part of a corporation's taxable income consists of capital gains, Section 1201(a) prescribes an "alternative" tax computation which must be used when it results in a lower tax than the tax computed under Section 11. The "alternative" computation of Section 1201(a) provides that a corporation shall determine its tax liability by computing the sum of (1) a "partial" tax imposed on its taxable income, at regular Section 11 rates, less capital gains (effectively leaving only its ordinary income subject to the "partial" tax); and (2) a "capital gains" tax imposed at a flat 25 percent rate on the previously excluded capital gains.

As the alternative tax computation employed by respondent for 1966 illustrates (p. 4, *supra*), its

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modification. See *e.g.*, Sections 593(b)(2)(E), 832(a) and 852(b)(2).

The only modifications contained within Section 172 are set forth in Section 172(b)(2)(B) (requiring the exclusion of the net operating loss for the current loss year or any other year thereafter) and Section 172(d) (which applies only to corporations eligible for the special deductions under Sections 242 and 922 and the computations allowed by Sections 243, 244, 245, 246(b), and 247 of the Code). None of these departures from the Section 63(a) definition of "taxable income" is applicable here.

entire 1968 loss was "used" to offset its taxable income for 1966. Indeed, the first mathematical operation of the computation prescribed by Section 1201 (a)—the substraction of the 1968 loss of $42,203.12 from respondent's 1966 income of $173,870.86, which reduced its taxable income for that year to $131,667.74—demonstrates that no part of the loss remained to offset income for 1967.

Contrary to the decision below, the fact that respondent's net capital gains ($166,634.81) exceeded its reduced taxable income ($131,667.74), so that its partial tax under the alternative computation was zero, does not support the conclusion that the 1968 loss was only "used" to the extent of respondent's ordinary income for 1966.[5] That loss had already been "used" to offset respondent's total taxable income (ordinary income plus capital gains) and had been completely absorbed in that process. Thus, the court below has misconceived the import of the alternative tax computation.

This analysis is confirmed by the congressional understanding that no net operating loss carryover is available as a deduction from a year in which the

[5] The Tax Court in *Chartier Real Estate Co.* reached this result by construing the phrase "to which such loss may be carried" in Section 172(b)(2) as modifying the term "taxable income" (see 52 T.C. at 358). However, the Fourth Circuit in *Mutual Assurance Society* specifically rejected this reading of the statute, stating that "[i]f Congress had intended to enact the rule in *Chartier Real Estate*, it certainly chose an obscure verbal formula to convey this meaning" (slip op. at 17).

taxpayer does not suffer an economic loss. See Detailed Discussion of Certain Technical Provisions of the Revenue Bill of 1939 (H. Rep. No. 855, 76th Cong., 1st Sess., p. 17). The figures for 1966 demonstrate that respondent did not suffer an economic loss for that year but in fact had net income of $131,667.74. Thus, there is no remaining loss carryover available to offset income for 1967.

3. We are advised by the Internal Revenue Service that with respect to this issue there are presently pending administratively cases involving 164 corporate taxpayers in which $30,740,027 of revenue is at stake. This figure does not reflect additional amounts which are expected to arise as a result of the attempts by taxpayers to claim net operating loss carryover deductions for succeeding years on the ground that portions of such losses are still available to offset income.[6] Indeed, current economic conditions in which many corporations are incurring losses could substantially increase the administrative importance of the question presented beyond the amount now at issue.

[6] For example, *Data Products Corp.* v. *United States*, *supra*, n. 2, which the district court decided adversely to the government, involves a refund claim of $152,451. However, the taxpayer has claimed an unused loss carryover in excess of $5,000,000.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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DECEMBER 1974.

APPENDIX A

IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF MISSOURI
WESTERN DIVISION

No. 19701-1

FOSTER LUMBER COMPANY, INC., PLAINTIFF

vs.

UNITED STATES OF AMERICA, DEFENDANT

MEMORANDUM AND ORDER

This case pends on a full factual stipulation filed April 14, 1972. The facts stipulated in that pretrial order numbered one through fifteen are incorporated by reference and made a part of this opinion. The Pretrial Order also provides that "The parties agree . . . that the issue in this case shall be decided on the basis of the agreed facts contained in this Order and the briefs to be submitted by the parties."

The sole issue, as stated by the plaintiff, is "whether under Section 172(b)(2) of the Internal Revenue Code of 1954 the net operating loss incurred in the fiscal period ending July 19, 1968, having been first carried back to reduce fiscal 1967 taxable income (1) only to the extent such loss exceeds the entire fiscal 1966 taxable income, including the capital gains segment which may not be reduced by such a net operating loss, as the government contends, or (2) to the

extent such loss exceeds that portion of fiscal 1966 taxable income to which such net operating loss may be carried, as the plaintiff contends."

The government candidly states that the only two decided cases on this issue have decided the issue in favor of the taxpayer. *Chartier* v. *Commissioner* (1969), 52 T.C. 346, affirmed (1st Cir., 1970), 423 F. 2d 474, and *Olympic Foundry Co.* v. *United States*, Civil No. 26-71C3 (W.D. Wash., February 9, 1972) appeal docketed No. 72-2128, 9th Cir., June 27, 1972. It submits, however, that the courts in those cases misconstrued Section 172(b)(2) of the Code, and therefore, the decision should not be followed by this Court.

We have carefully reviewed the briefs filed by the parties and the cases cited. We express our agreement with the rationale of *Chartier*, *supra*, and *Olympic Foundry Co.*, and the construction given Section 172(b)(2) by those courts.

We hold, therefore, that the operating loss incurred in fiscal 1968 may be carried to fiscal 1967 taxable income to the extent such loss exceeds that portion of fiscal 1966 taxable income against which the net operating loss may actually be applied in the recomputation of the tax due on fiscal 1966 income.

For the reasons stated it is

ORDERED that this memorandum opinion shall, pursuant to Rule 52 of the Rules of Civil Procedure,

be considered as our findings of fact and conclusions of law. It is further

ORDERED that the defendant shall promptly compute the amount of judgment and submit it to the plaintiff in order that an agreed form of judgment may be entered.

/s/ John W. Oliver
District Judge

Kansas City, Missouri
May 7, 1973

[Caption Omitted]

STIPULATIONS

The parties hereto stipulate and agree that venue is properly laid in this District; that the United States District Court for the Western District of Missouri, Western Division has jurisdiction of the parties hereto and subject matter hereof, and, that all proper, necessary and indispensable parties are before the Court. The following facts are admitted and require no proof:

1. Plaintiff, Foster Lumber Company, Inc., is a Colorado corporation with its principal office located at 912 East Sixty-Third Street, Kansas City, Missouri.

2. Plaintiff is the successor to Foster Lumber Company (a Missouri corporation, Liquidated on July 19, 1968) by virtue of the plaintiff's acquisition of substantially all the operating assets and liabilities of said Foster Lumber Company (hereafter referred to as the taxpayer) under an agreement dated November 22, 1967, in exchange solely for plaintiff's voting stock.

3. Taxpayer kept its books and records and filed its federal income tax returns on the basis of a fiscal year ending March 31.

4. Taxpayer timely filed its U.S. Corporation Income Tax Returns (Forms 1120) for its fiscal years ending March 31, 1966, March 31, 1967 and July 19, 1968, with the District Director of Internal Revenue, St. Louis, Missouri, and paid the amount of tax shown due on the returns.

5. Taxpayer realized taxable income for its fiscal year ending March 31, 1966 of $173,870.86, of which $7,236.05 was ordinary income and the remaining $166,634.81 was net long-term capital gain.

6. Taxpayer realized taxable income for its fiscal year ending March 31, 1967 of $228,917.73, of which $114,261.82 was ordinary income and the remaining $114,655.96 was net long-term capital gain.

7. Taxpayer suffered and reported a net operating loss of $42,203.12 for the fiscal year ending July 19, 1968.

8. Taxpayer filed a Corporation Application For Tentative Refund From Carryback of Net Operating Loss (Form 1139) on September 11, 1968, in which

taxpayer recomputed its tax for its taxable year ending March 31, 1966, taking into consideration the net operating loss carryback from its taxable year ending July 19, 1968.

9. The taxpayer's federal income tax liability for its fiscal year ending March 31, 1966, as computed under the regular method as provided under Section 11 of the Internal Revenue Code of 1954, was $58,-200.52, computed as follows:

Ordinary tax: 22% x ($173,870.86—net operating loss carryback of $42,203.12) =	$28,966.91
Surtax: 26% x ($173,879.86—$42.203.12—$25,000 =	27,733.61
Tax on multiple surtax exemption: 6% x $25,000 =	1,500.00
Total tax:	$58,200.52

10. The taxpayer's federal income tax liability for its fiscal year ending March 31, 1966, as computed under the alternative method as provided under Sections 11 and 1202 of the Internal Revenue Code of 1954, was $41,658.70, computed as follows:

Ordinary tax: 22% x ($7,236.05—net operating loss carryback of $7,236.05) =	—0—
Capital gains tax: 25% x $166,634.81 =	$41,658.70
Total tax:	$41,658.70

(The alternative method, as provided under Sections 11 and 1201 of the Code, was used in computing the taxpayer's tax liability for the fiscal year ended March 31, 1966.)

11. The taxpayer's federal income tax liability for its fiscal year ending March 31, 1967, as determined by the Internal Revenue Service, was $68,-136.45, computed as follows:

Ordinary tax: 48% x ($114,261.82—no net operating loss deduction)—$6500 =	$48,345.68
Capital gains tax: 25% x $114,853.96 =	28,663.99
	$77,009.67
Less: Investment credit	8,873.22
Total tax:	$68,136.45

(The taxpayer paid income tax in the amount of $68,136.45, for the fiscal year ending March 31, 1967. $67,300.74 was paid in accordance with its tax return and $835.91 was paid pursuant to a deficiency assessment.)

12. The taxpayer's federal income tax liability for its fiscal year ending March 31, 1967, as alleged by the plaintiff, was $51,352.28, computed as follows:

Ordinary tax: 23% x ($114,261.32—net operating less carryback of $34,967.07) =	$17,444.85
Surtax: 26% x [($114,261.82—34,967.07)—25,000] =	14,116.64
Capital gains tax: 25% x $114,655.96 =	28,663.99
	$60,225.48
Less: Investment credit	8,873.22
Total tax:	51,352.26

13. Taxpayer timely filed its Claim for refund (Form 843) with the Internal Revenue Service for its taxable year ending March 31, 1967 on January 23, 1970, claiming an overpayment of income tax in the amount of $16,784.39, computed as follows:

Tax paid	$68,136.65
(minus) Alleged correct tax liability	51,352.26
Alleged overpayment	$16,784.39

14. On or about December 9, 1970, the Internal Revenue Service disallowed taxpayer's Claim for refund.

15. This suit was timely instituted on September 11, 1971.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 73-1659

FOSTER LUMBER COMPANY, INC., APPELLEE

v.

UNITED STATES OF AMERICA, APPELLANT

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF MISSOURI

Submitted: January 18, 1974
Filed: July 29, 1974

Before MEHAFFY, Chief Judge, LAY
and ROSS, Circuit Judges

MEHAFFY, Chief Judge.

This is a refund suit by the successor in interest of a Missouri corporation to recover a portion of the

taxpayer's 1967 federal corporate income tax payment. The taxpayer bases its claim on a recomputation of its 1967 tax liability to include the carryback of a net operating loss it had incurred in 1968. The Internal Revenue Service disallowed taxpayer's claim on the ground that the net operating loss in question had been fully absorbed in the recomputation of taxpayer's 1966 tax liability. The district court sustained the taxpayer's refund claim, and IRS brought this appeal. For the reasons stated below we affirm the judgment of the district court.

The relevant facts have been stipulated and may be briefly stated. In fiscal 1966 the taxpayer realized $7,236.00 of ordinary income and $166,634.00 in net long-term capital gains. In fiscal 1967 the taxpayer realized $114,261.00 of ordinary income and $114,-656.00 in net long-term capital gains. In fiscal 1968 the taxpayer suffered a net operating loss of $42,-203.00. Pursuant to the provisions of INT. REV. CODE § 172 the taxpayer sought to carry back the 1968 net operating loss to its prior taxable years. The taxpayer first carried the net operating loss back to 1966, and there is no dispute over the taxpayer's recomputation of its 1966 tax liability.

Under the regular corporate income tax rates the 1966 liability was recomputed as follows:

Taxable Income as Originally Reported	$173,870.00
Net Operating Loss Deduction	42,203.00
Recomputed Taxable Income	$131,667.00
Regular Corporate Tax on Recomputed Taxable Income	$ 58,200.00

Under the alternative tax provided in section 1201 the 1966 tax liability was recomputed as follows:

Ordinary Income Element of Taxable Income	$ 7,236.00
Net Operating Loss Deduction	42,203.00
Recomputed Ordinary Income Element of Taxable Income	—0—
Net Long-Term Capital Gain Element of Taxable Income	$166,634.00
Tax on Recomputed Ordinary Income Element	—0—
Tax on Net Long-Term Capital Gain Element	41,658.00
Alternative Tax	$ 41,658.00

The alternative tax method resulted in a smaller 1966 tax liability than that computed under the regular rates, and the parties agree that the section 1201 alternative tax is controlling.

Given the agreement among the parties on the recomputed 1966 tax liability, the sole controversy presented here is over the amount of the net operating loss carryback that is available to be carried forward to 1967. The controlling statutory language, in pertinent part, states that:

> The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried.

INT. REV. CODE § 172(b)(2).

The taxpayer contends that the above-quoted language allows it to carry forward to 1967 the excess of the net operating loss over the amount of the 1966 taxable income to which the loss had been carried:

Net Operating Loss	$ 42,203.00
Taxable Income to which NOL Was Carried	7,236.00
NOL to be Carried Forward	$ 34,967.00

IRS contends that section 172(b)(2) allows taxpayer to carry forward only the excess of the net operating loss over the total amount of the taxable income for the year 1966:

Net Operating Loss	$ 42,203.00
Total Taxable Income	173,870.00
NOL to be Carried Forward	—0—

Stated somewhat differently, the issue in this case is whether the last phrase of section 172(b)(2), "to which such loss may be carried," modifies "taxable income" as well as the words "prior taxable years."

The taxpayer concedes that its interpretation of section 172(b)(2) is counter to the position announced in Treasury Regulation 1.172-4(b)(ii), but notes that every court which has considered the issue has squarely rejected the position taken by IRS. *Naegele* v. *United States*, 32 Am. Fed. Tax R.2d 73-5689 (D. Minn. 1973), *appeal docketed*, No. 73-1921, 8th Cir., Dec. 26, 1973; *Olympic Foundry Co.* v. *United States*, 29 Am. Fed. Tax R.2d 72-759 (D. Wash. 1972), *aff'd per curiam*, 493 F.2d 1247 (9th

Cir. 1974); *Sidney Axelrod*, 42 P-H Tax Ct. Mem. ¶ 73,190 (1973), *appeal docketed*, No. 74-1511, 6th Cir., May 7, 1974; *Mutual Assurance Society of Virginia Corporation*, 42 P-H Tax Ct. Mem. ¶ 73,177 (1973), *appeal docketed*, No. 74-1133, 4th Cir., Jan. 28, 1974; *Chartier Real Estate Company*, 52 T.C. 346 (1969), *aff'd per curiam*, 428 F.2d 474 (1st Cir. 1970). IRS concedes that the unanimous weight of judicial opinion is, at least thus far, against its position. IRS argues, however, that these cases are merely ill-considered reaffirmations of an allegedly aberrant secondary holding in the original Tax Court decision on this issue, *Chartier Real Estate Company*, *supra*. Each party also argues that its position is supported by the plain meaning of the statutory language and the policy behind that language.

As one should probably expect in a case involving the Internal Revenue Code, it is impossible to find any plain meaning in the statutory language that would dispose of this controversy. Given the typically tortured wording of the Code, we feel that each of the parties' interpretations presents a plausible reading of section 172(b)(2) on its face. Moreover, the legislative history offers little assistance in ascertaining Congress's intent. Neither party has cited, nor have we been able to find, any legislative history that directly addresses the issue presented in this appeal. We are convinced, however, that the basic policy considerations underlying sections 1201 and 172 decisively support the result reached by the district court.

The basic purpose behind the net operating loss carryback provisions of section 172 is to ameliorate the harsh tax consequences that can result from the necessity of accounting for certain exceptional economic events within the confines of an arbitrary annual accounting period. The purpose behind the alternative tax in section 1201 is to alter the tax rate to reflect the traditionally unique character of income arising out of the sale of capital assets. These purposes are quite distinct, as are the economic events with which they are concerned. IRS contends that the taxpayer's position in this case will result in a double benefit. We agree that the tax benefits of the separate provisions may under certain circumstances be "double," at least in the sense that they are cumulative. But, given the differing purposes behind each benefit, we see no reason why the chance relative timing of basically unrelated economic events should negate the cumulative impact of the separate provisions. Indeed, to hold otherwise would frequently subject otherwise similarly situated taxpayers to significantly different treatment solely on the basis of arbitrary timing; precisely the reverse of section 172's original purpose.

In reaching our conclusion we have carefully examined the Internal Revenue Service's argument regarding the judicial decisions on the issue presently before us. None of the decisions is binding precedent in this court, and several of the opinions are quite brief in their discussion of the issue. Nevertheless, we cannot dismiss lightly the cumulative weight of

our fellow judges' decisions or the divisiveness and administrative confusion that a contrary conclusion at this point might foster.

The judgment of the district court is affirmed.

A true copy.

Attest:

Clerk, U. S. Court of Appeals, Eighth Circuit.

APPENDIX C

JUDGMENT

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

SEPTEMBER TERM, 1973

[Filed Jul. 29, 1974, Robert C. Tucker, Clerk]

No. 73-1659

FOSTER LUMBER COMPANY, INC., APPELLEE

vs.

UNITED STATES OF AMERICA, APPELLANT

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF MISSOURI

THIS CAUSE came on to be heard on the record from the United States District Court for the Western District of Missouri and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now here ordered and adjudged by this Court, that the

judgment of the said District Court, in this cause, be, and the same is hereby, affirmed.

July 29, 1974

Costs taxed
in favor of
Appellee:

Costs of printing 25 copies of Appellee's brief:	$49.30
Total cost of Appellee for recovery from Appellant in the U. S. District Court:	$49.30

[SEAL]

A true copy:

Attest: /s/ Robert C. Tucker

Clerk, U. S. Court of Appeals, 8th Circuit.

APPENDIX D

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 63. TAXABLE INCOME DEFINED.

(a) *General Rule.*—Except as provided in subsection (b), for purposes of this subtitle the term "taxable income" means gross income, minus the deductions allowed by this chapter, other than the standard deduction allowed by part IV (sec. 141 and following).

* * * *

SEC. 172. NET OPERATING LOSS DEDUCTION.

(a) *Deduction Allowed.*—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

(b) [as amended by Sec. 317(b), Trade Expansion Act of 1962, P.L. 87-794, 76 Stat. 872] *Net Operating Loss Carrybacks and Carryovers.*—

(1) *Years to which loss may be carried.*—

(A) (i) [as amended by Sec. 210 (a)(1), Revenue Act of 1964, P.L. 88-272, 78 Stat. 19 and Sec. 3(a)(1), Act of December 27, 1967, P.L. 90-225, 81 Stat. 730] Except as provided in clause

(ii) and subparagraphs (D) and (E), a net operating loss for any taxable year ending after December 31, 1957, shall be a net operating loss carryback to each of the 3 taxable years preceding the taxable year of such loss.

(ii) In the case of a taxpayer with respect to a taxable year ending on or after December 31, 1962, for which a certification has been issued under section 317 of the Trade Expansion Act of 1962, a net operating loss for such taxable year shall be a net operating loss carryback to each of the 5 taxable years preceding the taxable year of such loss.

• • • •

(2) *Amount of carrybacks and carryovers.*—Except as provided in subsections (i) and (j), the entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the "loss year") shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. For purposes of the preceding sentence, the taxable income for any such prior taxable year shall be computed—

(A) with the modifications specified in subsection (d) other than paragraphs (1), (4), and (6) thereof; and

(B) [as amended by Sec. 210(b)(1) and (2), Revenue Act of 1964, *supra*] by determining the amount of the net operating loss deduction—

(i) without regard to the net operating loss for the loss year or for any taxable year thereafter, and

(ii) without regard to that portion, if any, of a net operating loss for a taxable year attributable to a foreign expropriation loss, if such portion may not, under paragraph (1)(D), be carried back to such prior taxable year,

and the taxable income so computed shall not be considered to be less than zero. For purposes of this paragraph, if a portion of the net operating loss for the loss year is attributable to a foreign expropriation loss to which paragraph (1)(D) applies, such portion shall be considered to be a separate net operating loss for such year to be applied after the other portion of such net operating loss.

• • • •

(d) *Modifications.* — The modifications referred to in this section are as follows:

• • • •

(2) *Capital gains and losses of taxpayers other than corporations.*—In the case of a taxpayer other than a corporation—

* * * *

(B) the deduction for long-term capital gain provided by section 1202 shall not be allowed.

* * * *

SEC. 1201. ALTERNATIVE TAX.

(a) [as amended by Sec. 8(g)(3), Revenue Act of 1962, P.L. 87-834, 76 Stat. 960] *Corporations.*—If for any taxable year the net long-term capital gain of any corporation exceeds the net short-term capital loss, then, in lieu of the tax imposed by sections 11, 511, 821(a) or (c), and 831(a), there is hereby imposed a tax (if such tax is less than the tax imposed by such sections) which shall consist of the sum of—

(1) a partial tax computed on the taxable income reduced by the amount of such excess, at the rates and in the manner as if this subsection had not been enacted, and

(2) an amount equal to 25 percent of such excess, or, in the case of a taxable year beginning before April 1, 1954, an amount equal to 26 percent of such excess.

In the case of a taxable year beginning before April 1, 1954, the amount under paragraph (2) shall be determined without regard to section 21 (relating to effect of change of tax rates).

* * * *

SEC. 1202. DEDUCTION FOR CAPITAL GAINS.

In the case of a taxpayer other than a corporation, if for any taxable year the net long-term capital gain exceeds the net short-term capital loss, 50 percent of the amount of such excess shall be a deduction from gross income. In the case of an estate or trust, the deduction shall be computed by excluding the portion (if any), of the gains for the taxable year from sales or exchanges of capital assets, which, under sections 652 and 662 (relating to inclusions of amounts in gross income of beneficiaries of trusts), is includible by the income beneficiaries as gain derived from the sale or exchange of capital assets.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1974 565113 93

Supreme Court, U. S.
FILED
MAY 15 1975
MICHAEL RODAK, JR., CLERK

APPENDIX

In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-799

UNITED STATES OF AMERICA,

Petitioner

—*v.*—

FOSTER LUMBER COMPANY, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI FILED DECEMBER 24, 1974
CERTIORARI GRANTED MARCH 31, 1975

In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-799

UNITED STATES OF AMERICA, *Petitioner*

—*v.*—

FOSTER LUMBER COMPANY, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

INDEX

	Page
Relevant Docket Entries:	
District Court	1
Court of Appeals	3
Complaint	5
Answer	11
Portion of Pre-trial Order Containing Parties' Stipulations	14
Notation Re Memorandum and Order of District Court	17
Judgment of District Court	18
Notice of Appeal	19
Notation Re Opinion of Court of Appeals	20
Notation Re Judgment of Court of Appeals	20
Order of the Supreme Court of the United States Granting a Writ of Certiorari	21

RELEVANT DOCKET ENTRIES U.S. DISTRICT COURT

(W.D. Missouri No. 19701-1)

Date	Filings and Proceedings
Sept. 13, 1971	COMPLAINT—FILED: Writ & 3 copies issued and delivered to the U.S. Marshal. FEE PAID.
Sept. 14, 1971	WRIT showing service on September 13, 1971 —filed. FEE PAID.
Nov. 16, 1971	ANSWER—FILED
Nov. 17, 1971	PRE-TRIAL ORDER No. 1—FILED. (Discovery April 11, 1972) Mailed.
Mar. 27, 1972	NOTICE to Counsel—FILED. Mailed
Apr. 14, 1972	PRE-TRIAL ORDER—Nature of the Case—FILED. (Stipulations: Plaintiff's statement of the Issue; Defendant's statement of the issue; schedule of briefs; Orders of the Court.) Copies distributed.
May 1, 1972	PLAINTIFF'S BRIEF—FILED.
May 24, 1972	BRIEF for the Defendant—FILED.
May 26, 1972	ADDENDUM to Brief for the Defendant—FILED. Submitted.
May 30, 1972	REPLY BRIEF of Plaintiff—FILED. Submitted.
May 7, 1973	MEMORANDUM and ORDER—FILED. (IT IS ORDERED that this memorandum OPINION shall be considered (pursuant to Rule 52, F.R.Cv.P.) as the Court's findings of fact and conclusions of law. Defendant to compute the amount of judgment as outlined herein and submit an order that agreed form of judgment may be entered. JWO) Copies to counsel.

Date	Filings and Proceedings
Jul. 17, 1973	JUDGMENT—FILED. (This cause having been submitted on stipulation, briefs and arguments of counsel in open court, and the Court being fully advised on the issue herein; IT IS ORDERED AND ADJUDGED that the plaintiff have and recover of the defendant the sum of $16,046.70 plus interest thereon at six percent (6%) per annum from July 19, 1968, as allowed by law, and $835.91 plus interest thereon at six percent (6%) per annum from June 30, 1969, as allowed by law, and its costs herein. JWO) Copies to counsel.
Jul. 18, 1973	COST STATEMENT MAILED.
Jul. 24, 1973	BILL OF COSTS ($23.00)—FILED
Sept. 12, 1973	NOTICE OF APPEAL—FILED. Copies sent to printer.

RELEVANT DOCKET ENTRIES U.S. COURT OF APPEALS

(C.A. 8—No. 73-1659)

Date	Filings and Proceedings
Sept. 17, 1973	DOCKETING CASE. Certified copies of Notice of Appeal and Docket entries in U.S. District Court
Sept. 26, 1973	DESIGNATION of Appellant of appendix
Oct. 5, 1973	APPEARANCE for appellant
Oct. 23, 1973	Request of appellant for extension of time to Nov. 26, 1973 to file appendix and brief.
Oct. 24, 1973	ORDER: Aplnt gr to Nov. 26, to file apndx & brf.
Nov. 28, 1973	*Appendix with service.*
Nov. 28, 1973	*Brief appellant* with service.
Nov. 28, 1973	Appearance for appellant.
Dec. 3, 1973	Submitted to screening panel.
Dec. 17, 1973	Transferred to January session.
Dec. 26, 1973	*Brief appellee.*
Dec. 26, 1973	Affidavit of service of brief appellee.
Jan. 7, 1974	REPLY BRIEF OF APPELLANT with service.
Jan. 14, 1974	MOTION of Naegele Advertising Cos. for leave to file brief as amicus curiae
Jan. 15, 1974	ORDER: Naegele Advertising Co. gr lv to file brief amicus curiae; Clerk to file same. Ct. to hear oral arg from amicus only if time relinquished by parties.
Jan. 15, 1974	BRIEF AMICUS CURIAE (*Naegele Advertising Companies, Inc.*) with service Orig. & 4

Date	Filings and Proceedings
Jan. 18, 1974	Arg. and sub. to J. Mehaffy, Lay Ross. (Recorded) Aplnt: Donald H. Olson, Dept. of Justice; Aplee: Robert Vancrum; Concl. Olson.
Jan. 21, 1974	Appearance for appellee.
Jan. 31, 1974	Answer of amicus curiae to Reply to Amicus curiae brief
July 29, 1974	Opinion by J. Mehaffy, Chief Judge. (Pr, Pub)
July 29, 1974	JUDGMENT: Judgment of D. Ct. affirmed.
Aug. 5, 1974	BILL OF COSTS of appellee.
Aug. 21, 1974	Mandate issued.
Aug. 28, 1974	Receipt of Mandate
Jan. 3, 1975	Notice of filing petition for certiorari in Sup. Ct. as 74-799

THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF MISSOURI

Civil Action File No. 19701-1

[Filed Sep. 13, 1971]

FOSTER LUMBER COMPANY, INC.,
912 E. 63rd St.
Kansas City, Missouri 64111, PLAINTIFF

vs.

UNITED STATES OF AMERICA, DEFENDANT

Serve: U.S. District Attorney
Western District of Missouri
811 Grand Avenue
Kansas City, Missouri 64106

Service by Certified Mail:

(1) Attorney-General of the
United States
U.S. Department of Justice
Room 5115
Washington, D.C. 20530

(2) District Director of
Internal Revenue
1114 Market St.
St. Louis, Missouri 63101

COMPLAINT

1. This is an action under the Internal Revenue Code of 1954, Sections 172(b) and 7422(a), for the refund of an overpayment of $16,784.39 paid by Foster Lumber Company as federal income tax for the taxable year ended March 31, 1967. This court has jurisdiction of the action pursuant to Section 1346(a)(1) of Title 28, United States Code.

2. Plaintiff Foster Lumber Company, Inc. (hereinafter "Foster"), a Colorado corporation with its principal office located at 912 East Sixty-Third Street, Kansas City, Missouri, is the successor to Foster Lumber Company (hereinafter "Taxpayer") (formerly a Missouri corporation, liquidated on July 19, 1968) by virtue of having acquire substantially all of the operating assets and liabilities of said Foster Lumber Company under an agreement dated November 22, 1967 (the "Transfer Agreement"). A copy of the Transfer Agreement is attached as Exhibit A and is hereby made a part hereof.

3. Foster brings the present action in its own name as the real party in interest to the present controversy. Taxpayer cannot bring an action for refund since it filed Articles of Dissolution more than two years prior to the commencement of this action and therefore lacks capacity to sue by virtue of Section 351.565 of the Revised Statutes of Missouri. Further, Taxpayer could not have instituted this action within the two year period of Section 351.565, since it did not receive written notice of the disallowance of its claim by the District Director until December 9, 1970, more than two years after the filing of its Articles of Dissolution.

4. Taxpayer kept its books and records and filed its federal income tax returns on the basis of a fiscal year ending March 31. It filed its federal income tax returns for its taxable years ended March 31, 1966, March 31, 1967, and July 19, 1968 (the taxable years here involved), with the District Director of Internal Revenue at St. Louis, Missouri.

5. In its federal income tax return for the year ended July 19, 1968, filed September 11, 1968, Taxpayer reported a net operating loss of $42,203.12, as shown in a copy of its return marked Exhibit B, attached and hereby made a part hereof. Such a net operating loss can be carried back to offset taxable income for the three preceding taxable years pursuant to Section 172, Internal Revenue Code of 1954.

6. Taxpayer had reported taxable income for the year ended March 31, 1966. the taxable year third preceding the taxable year of the net operating loss, of

$172,977.80, of which amount $166,634.81 was the excess of net long-term capital gain over net short-term capital loss and $6,342.99 was ordinary taxable income. Taxpayer had paid the income tax on that amount of taxable income plus a tax imposed by Section 1562(b) of the Internal Revenue Code of 1954 upon members of a controlled group of corporations electing multiple surtax exemptions.

7. On September 11, 1968, in pursuance of its obligations under the Transfer Agreement included herein as Exhibit A, Taxpayer filed an application for tentative refund from carryback of net operating loss—Internal Revenue Service Form 1139, in which it recomputed its tax for the taxable year ended March 31, 1966, taking into consideration the net operating loss carryback deduction from the taxable year ended July 19, 1968.

8. Taxpayer, in recomputing its tax liability on Form 1139 for the taxable year ended March 31, 1966, and the representative of the District Director of Internal Revenue at St. Louis, in his recomputation of the Taxpayer's income tax for the taxable year ended March 31, 1966 (as shown in his examination report dated May 9, 1969, copy of which is attached as Exhibit C and hereby is made a part hereof) calculated Taxpayer's income tax by both the method of computation prescribed in Section 11 of the Internal Revenue Code of 1954 ("the regular method") and the method prescribed in Section 1201(a) of the Internal Revenue Code of 1954 ("the alternative method").

9. The representative of the District Director decreased allowable depreciation expense and hence raised taxable income by $893.06, but otherwise the recomputations by the Taxpayer and the District Director of the Taxpayer's income tax for the taxable year ended March 31, 1966, were the same and therefore the Taxpayer and the District Director agreed upon a recomputation on or about May 29, 1969.

10. Taxpayer's tax for the taxable year ended March 31, 1966, as recomputed by the regular method by the representative of the District Director was $58,200.52, computed as follows (as shown in Exhibit C):

Ordinary tax: 22% x ($173,870.86—$42,203.12)	=	$28,966.91
Surtax: 26% x ($173,870.85—$42,203.12—$25,000)	=	27,733.61
Tax on multiple surtax exemption: 6% x $25,000.00	=	1,500.00
Total Tax:		$58,200.52

The representative of the District Director recomputed the Taxpayer's tax for the taxable year ended March 31, 1966, by the alternative method as follows (as also shown in Exhibit C):

Ordinary tax: 22% x ($7,236.05—$7,236.05)	=	0
Capital gains tax: 25% x $166,634.81	=	$41,658.70
Total Tax:		$41,658.70

Since the alternative method yielded the lower tax, both Taxpayer and the representative of the District Director used that method in determining the Taxpayer's final tax liability for the taxable year ended March 31, 1966.

11. Under the alternative method of computation, only $7,236.05 of the net operating loss deduction arising from the taxable year ended July 19, 1968, was absorbed in offsetting the Taxpayer's ordinary income for the taxable year ended March 31, 1966, leaving an unused net operating loss deduction of $34,967.07 to be carried to and applied against the plaintiff's ordinary taxable income arising in the taxable year ended March 31, 1967, pursuant to Section 172 of the Internal Revenue Code of 1954.

12. Taxpayer had ordinary taxable income for the year ended March 31, 1967, of $114,261.82, as revised by a representative of the District Director in his report prepared on June 4, 1969, a copy of which is attached as Exhibit D and hereby is made a part hereof. Taxpayer's long term capital gain for the year ended March 31, 1967, was $114,655.96, as also shown in Exhibit F. Accepting the computations shown in the report included herein as Exhibit D, Taxpayer agreed to and paid an income tax for the taxable year ended March 31, 1967, of $68,136.45, after allowance of an investment credit of $8,873.22. Taking account of the

unabsorbed net operating loss carryback deduction of $34,967.07, Taxpayer calculated its correct final tax liability for the taxable year ended March 31, 1967, as follows:

Ordinary income tax:		
Normal tax: 22% x ($114,261.82—$34,967.07)	=	$17,444.85
Surtax: 26% x [($114,261.82—$34,967.07) $25,000.00]	=	$14,116.64
Tentative Tax Liability:		$60,235.45
Less: Investment Credit:		8,873.22
Correct Final Tax Liability		$51,352.23

13. The overpayment of tax by Taxpayer for the taxable year ended March 31, 1967, is $16,784.39, which is computed:

Tax paid for year	$68,136.65
Correct Tax Liability after Net Operating Loss Deduction	$51,352.26
Overpayment of Tax	$16,784.39

14. On January 22, 1970, Taxpayer filed its claim for refund with the District Director of Internal Revenue at St. Louis, Missouri, with respect to its taxable year ended March 31, 1967, a copy of which claim is attached as Exhibit E. As that document shows, Taxpayer's claim, based upon *Chartier Real Estate Company, Inc.* v. *Commissioner*, 52 T.C. 346, 356-58 (U.S. Tax Court, 1969), aff'd 428 F.2d 474 (1st Cir. 1970), was that it should be permitted to carry its unused net operating loss deduction of $34,967.07 to the taxable year ended March 31, 1967, and offset it against part of its ordinary taxable income of $114,261.82, thereby yielding an overpayment of $16,784.39 for the taxable year ended March 31, 1967.

15. On or about December 9, 1970, Taxpayer received written notification of the disallowance of its claim for refund of $16,784.39 by the District Director. As that notification, attached as Exhibit F hereof, clearly indicates, the disallowance was solely on the grounds

that the Commissioner does not acquiesce in the holding of the Tax Court of the United States and the First Circuit Court of Appeals in *Chartier Real Estate Company, Inc.* v. *Commissioner*, 52 T.C. 346, 356-58 (1969), aff'd 428 F.2d 474 (1970).

16. Since the District Director cited a nonacquiescence as the grounds for disallowing Taxpayer's claim, it would be futile to seek review of that disallowance by the Appellate Division of the Internal Revenue Service and such review is not a prerequisite to the maintenance of the present action, under Sections 7422(a) and 6532(a)(1), Internal Revenue Code of 1954.

17. Plaintiff Foster is entitled to the refund of the $16,784.39 overpayment of income taxes for the taxable year ending March 31, 1967.

WHEREFORE, plaintiff demands judgment against defendant for the sum of $16,784.39, plus interest at 6% per annum from July 19, 1968, being the end of the taxable year in which the net operating loss arose and thus the date on which the overpayment may be deemed to have been made, and for all costs of this action.

WATSON, ESS, MARSHALL & ENGGAS

/s/ Robert J. Vancrum
Robert J. Vancrum

/s/ John F. Marvin
John F. Marvin
1500 Home Savings Building
1006 Grand Avenue
Kansas City, Mo.
VI 2-3132

Attorneys for Plaintiff

IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF MISSOURI
WESTERN DIVISION

Civil Action No. 19701-1

[Filed November 16, 1971]

FOSTER LUMBER COMPANY, INC., PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

ANSWER

The defendant, United States of America, for its Answer to plaintiff's Complaint admits, denies and alleges as follows:

Denies the allegations of such Complaint admitted, qualified or otherwise specifically referred to as follows:

Further answering, the defendant:

1. Admits that this is an action by the plaintiff to recover income taxes paid, but denies that plaintiff has overpaid its income taxes. Admits that jurisdiction, if any, is by virtue of Title 28, U.S.C. Section 1346(a)(1).

2. Admits the allegations contained in paragraph two of the Complaint.

3. Admits the allegations contained in paragraph three of the Complaint.

4. Admits the allegations contained in paragraph four of the Complaint.

5. Denies the allegations contained in paragraph five of the Complaint.

6. Admits the allegations contained in paragraph six of the Complaint, but denies that such reported income reflects an accurate statement of taxpayer's taxable income or tax liability for the taxable year ended March 31, 1966.

7. Presently lacks knowledge or information sufficient to form a belief as to the truth of the allegations contained in paragraph seven of the Complaint.

8. Presently lacks knowledge or information sufficient to form a belief as to the truth of the allegations contained in paragraph eight of the Complaint.

9. Admits the allegations contained in paragraph nine of the Complaint, but denies that such recomputations reflect an accurate statement of taxpayer's taxable income or tax liability for the taxable year ended March 31, 1966.

10. Denies the allegations contained in paragraph ten of the Complaint.

11. Denies the allegations contained in paragarph eleven of the Complaint.

12. Denies the allegations contained in paragraph twelve of the Complaint.

13. Denies the allegations contained in paragraph thirteen of the Complaint.

14. Denies the allegations contained in paragraph fourteen of the Complaint, but admits that the taxpayer filed a claim for refund on or about January 22, 1970, but further denies each and every allegation contained in the referenced claim, Exhibit E, not specifically admitted or qualified elsewhere in this Answer.

15. Admits the allegations contained in the first sentence in paragraph fifteen of the Complaint, but denies the allegations contained in the second sentence in paragraph fifteen of the Complaint.

16. Denies the allegations contained in paragraph sixteen of the Complaint.

17. Denies the allegation contained in paragraph seventeen of the Complaint.

WHEREFORE, the defendant denies that plaintiff is entitled to recover the amount claimed or any amount of money whatsoever, and prays that judgment be entered in favor of the defendant, together with its costs

and such other and further relief as this Court deems to be just and proper.

BERT C. HURN
United States Attorney

By: _____

ROBERT S. MILIGAN
Trial Attorney
Refund Trial Section No. 3
Tax Division
Department of Justice
Washington, D.C. 20530
Telephone (202)-739-3737

[Caption omitted]

STIPULATIONS

The parties hereto stipulate and agree that venue is properly laid in this District; that the United States District Court for the Western District of Missouri, Western Division has jurisdiction of the parties hereto and subject matter hereof, and, that all proper, necessary and indispensable parties are before the Court. The following facts are admitted and require no proof:

1. Plaintiff, Foster Lumber Company, Inc., is a Colorado corporation with its principal office located at 912 East Sixty-Third Street, Kansas City, Missouri.

2. Plaintiff is the successor to Foster Lumber Company (a Missouri corporation, Liquidated on July 19, 1968) by virtue of the plaintiff's acquisition of substantially all the operating assets and liabilities of said Foster Lumber Company (hereafter referred to as the taxpayer) under an agreement dated November 22, 1967, in exchange solely for plaintiff's voting stock.

3. Taxpayer kept its books and records and filed its federal income tax returns on the basis of a fiscal year ending March 31.

4. Taxpayer timely filed its U.S. Corporation Income Tax Returns (Forms 1120) for its fiscal years ending March 31, 1966, March 31, 1967 and July 19, 1968, with the District Director of Internal Revenue, St. Louis, Missouri, and paid the amount of tax shown due on the returns.

5. Taxpayer realized taxable income for its fiscal year ending March 31, 1966 of $173,870.86, of which $7,236.05 was ordinary income and the remaining $166,634.81 was net long-term capital gain.

6. Taxpayer realized taxable income for its fiscal year ending March 31, 1967 of $228,917.73, of which $114,-261.82 was ordinary income and the remaining $114,-655.96 was net long-term capital gain.

7. Taxpayer suffered and reported a net operating loss of $42,203.12 for the fiscal year ending July 19, 1968.

8. Taxpayer filed a Corporation Application For Tentative Refund From Carryback of Net Operating Loss (Form 1139) on September 11, 1968, in which taxpayer recomputed its tax for its taxable year ending March 31, 1966, taking into consideration the net operating loss carryback from its taxable year ending July 19, 1968.

9. The taxpayer's federal income tax liability for its fiscal year ending March 31, 1966, as computed under the regular method as provided under Section 11 of the Internal Revenue Code of 1954, was $58,200.52, computed as follows:

Ordinary tax: 22% x ($173,870.86—net operating loss carryback of $42,203.12)	=	$28,966.91
Surtax: 26% x ($173,870.86 [1]—$42,203.12—$25,000	=	27,733.61
Tax on multiple surtax exemption: 6% x $25,000	=	1,500.00
Total tax:		$58,200.52

10. The taxpayer's federal income tax liability for its fiscal year ending March 31, 1966, as computed under the alternative method as provided under Sections 11 and 1201 of the Internal Revenue Code of 1954, was $41,658.70, computed as follows:

Ordinary tax: 22% x ($7,236.05—net operating loss carryback of $7,236.05)	=	—0—
Capital gains tax: 25% x $166,634.81	=	$41,658.70
Total tax:		$41,658.70

(The alternative method, as provided under Sections 11 and 1201 of the Code, was used in computing the taxpayer's tax liability for the fiscal year ended March 31, 1966.)

11. The taxpayer's federal income tax liability for its fiscal year ending March 31, 1967, as determined by the Internal Revenue Service, was $68,136.45, computed as follows:

---

[1] In the original stipulation of facts, and in the record below, this figure appears erroneously as $173,879.86, as counsel for both parties agree.

Ordinary tax: 48% x ($114,261.82—no net operating loss deduction)—$6500	=	$48,345.68
Capital gains tax: 25% x $114,853.96	=	28,663.99
Less: Investment credit		8,873.22
Total tax:		$68,136.45

(The taxpayer paid income tax in the amount of $68,-136.45, for the fiscal year ending March 31, 1967, $67,-300.74 was paid in accordance with its tax return and $835.91 was paid pursuant to a deficiency assessment.)

12. The taxpayer's federal income tax liability for its fiscal year ending March 31, 1967, as alleged by the plaintiff, was $51,352.28, computed as follows:

Ordinary tax: 22% [2] x ($114,261.82 [3]—net operating loss carryback of $34,967.07)	=	$17,444.85
Surtax: 26% x [($114,261.82—$34,967.07)—25,000]		14,116.64
Capital gains tax: 25% x $114,655.96	=	28,663.99
		$60,225.48
Less: Investment credit		8,873.22
Total tax:		51,352.26

13. Taxpayer timely filed its Claim for refund (Form 843) with the Internal Revenue Service for its taxable year ending March 31, 1967 on January 22, 1970, claiming an overpayment of income tax in the amount of $16,784.39, computed as follows:

Tax paid	$68,136.65
(minus) Alleged correct tax liability	51,352.26
Alleged overpayment	$16,784.39

14. On or about December 9, 1970, the Internal Revenue Service disallowed taxpayer's Claim for refund.

15. This suit was timely instituted on September 11, 1971.

---

[2] In the original stipulation of facts and in the record below this figure appears erroneously as 23%, as counsel for both parties agree.

[3] In the Appendix to the Petition for Certiorari this figure appears erroneously as $114,261.32 (Pet. App. 6a.).

NOTATION RE MEMORANDUM AND ORDER OF DISTRICT COURT

The Memorandum and Order of the District Court is printed in the Petition for Certiorari, and may be found therein at pages 1a-3a of Appendix A. It is therefore not reprinted in this Appendix.

IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF MISSOURI
WESTERN DIVISION

Civil No. 19701-1

[Filed Jul. 17, 1973]

FOSTER LUMBER COMPANY, INC., PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

JUDGMENT

This action having been submitted to the Court on the basis of a stipulation, and certain attachments thereto, plus the briefs and arguments of counsel in open Court, and this Court being fully advised of the issue herein, and having found for the plaintiff thereon, it is hereby,

ORDERED and ADJUDGED that plaintiff shall have of and recover from the defendant the sum of $16,046.70 plus interest thereon at six percent (6%) per annum from July 10, 1968, as allowed by law, and $835.91 plus interest thereon at six percent (6%) per annum from June 30, 1969, as allowed by law, and its costs herein.

/s/ [Illegible]
United States District Judge

Approved as to Form:

/s/ Robert Vancrum
ROBERT VANCRUM
Counsel for Plaintiff

/s/ Douglas G. Anderson
DOUGLAS G. ANDERSON
Counsel for Defendant

/s/ [Illegible]
Assistant U.S. Attorney
Counsel for Defendant

IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF MISSOURI
WESTERN DIVISION

Civil No. 19701-1

[Filed Sep. 12, 1973]

FOSTER LUMBER COMPANY, INC., PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

NOTICE OF APPEAL

Notice is hereby given that the United States of America, defendant, hereby appeals to the United States Court of Appeals For The Eighth Circuit from the final judgment entered in this cause on July 17, 1973.

BERT C. HURN
United States Attorney

by /s/ Mary A. Senner
MARY A. SENNER
Asst. United States Attorney

I hereby certify that a copy of the foregoing was mailed to Robert J. Vancrum, Attorney at Law, WATSON, ESS, MARSHALL & ENGGAS, 1006 Grand Avenue, Kansas City, Missouri 64106, this 12th day of September, 1973.

/s/ Mary A. Senner
MARY A. SENNER
Assistant United States Attorney

NOTATION RE OPINION OF COURT OF APPEALS

The Opinion of the Court of Appeals is printed in the Petition for Certiorari, and may be found therein at pages 8a-14a of Appendix B. It is therefore not reprinted in this Appendix.

NOTATION RE JUDGMENT OF COURT OF APPEALS

The Judgment of the Court of Appeals is printed in the Petition for Certiorari, and may be found therein at pages 15a-16a of Appendix C. It is therefore not reprinted in this Appendix.

SUPREME COURT OF THE UNITED STATES

No. 74-799

UNITED STATES, PETITIONER

v.

FOSTER LUMBER COMPANY, INC.

ORDER ALLOWING CERTIORARI—Filed March 31, 1975

The petition herein for a writ of certiorari to the United States Court of Appeals for the Eighth Circuit is granted.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1975 573265 142

Supreme Court, U. S.
FILED
MAR 6 1975
MICHAEL RODAK, JR., CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-799

UNITED STATES OF AMERICA,
Petitioner,

vs.

FOSTER LUMBER COMPANY, INC.,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF OF THE RESPONDENT IN OPPOSITION

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INDEX

Question Presented 1

Reasons for Denying the Petition for Writ of Certiorari 2

Conclusion 4

Citations

CASES

Chartier Real Estate Co. v. *Commissioner*, 52 T.C. 346 (1969), affirmed *per curiam* 428 F.2d 474 (1970) 2

Commissioner v. *Lester*, 366 U.S. 299, 307 (1961) 4

Data Products Corporation v. *United States*, ... F.2d ..... (decided September 25, 1974) 2

Dobson v. *Commissioner*, 320 U.S. 489 (1943) 3

Knetsch v. *United States*, 364 U.S. 361 (1960) 4

McDonald v. *Commissioner*, 323 U.S. 57 (1944) 3

Mutual Assurance Society of Virginia v. *Commissioner*, 505 F.2d 128 (1974) 2

Olympic Foundry v. *United States*, 493 F.2d 1247 (1974) 2

United States v. *Skelly Oil Company*, 394 U.S. 678 (1969) 4

STATUTES

Internal Revenue Code of 1954, 26 U.S.C., Sec. 1201 1

In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-799

UNITED STATES OF AMERICA,
Petitioner,

vs.

FOSTER LUMBER COMPANY, INC.,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR
THE EIGHTH CIRCUIT

BRIEF OF THE RESPONDENT IN OPPOSITION

QUESTION PRESENTED

The issue in this tax case is whether, in carrying back a net operating loss to a year in which the taxpayer had ordinary income and capital gain of such amounts that Section 1201 of the Internal Revenue Code (providing for the so-called "alternative tax") was required to be used in determining the tax for that year, the loss available for carryover to a succeeding year is the amount by which the loss exceeds only the ordinary income for the prior year, as the decision below held, or the amount by which the loss exceeds both the ordinary income and capital gain for the prior year.

Parallel Petitions for Writs of Certiorari Now Pending

This case raises the identical issue as *Data Products Corporation* v. *United States*, judgment in which was entered by the United States Court of Appeals for the Ninth Circuit on December 27, 1974, and which is not yet officially reported. Petitions for writs of certiorari in that case have been filed both by Data Products Corporation, No. 74-854, and by the United States, No. 74-996.

REASONS FOR DENYING THE PETITION FOR WRIT OF CERTIORARI

The issue raised by this case and by the *Data Products Corporation* case is purely technical and computational in nature. It involves no significant problem of tax philosophy or tax policy. This sort of issue is hardly a matter of sufficient importance to merit the attention of this Court.

Furthermore, the law on this issue has been well settled, with not only the First,[1] Eighth,[2] and Ninth[3] Circuits, but also the Tax Court[4] holding in favor of the taxpayer. Only recently was the United States able to obtain an apparently conflicting decision by the Fourth Circuit.[5] However, in view of the taxpayer's small economic stake in that Fourth Circuit case (so small that the taxpayer, know-

1. *Chartier Real Estate Co.* v. *Commissioner*, 428 F.2d 474 (1970), affirming the decision of the Tax Court cited in footnote 4.

2. *United States* v. *Foster Lumber Company, Inc.*, 500 F.2d 1230 (1974), the decision below in the present case.

3. *Data Products Corporation* v. *U. S.*, ... F.2d ..... (1974); *Olympic Foundry* v. *U. S.*, 493 F.2d 1247 (1974).

4. *Chartier Real Estate Co.* v. *Commissioner*, 52 T.C. 346 (1969). The Tax Court has continued to follow this decision.

5. *Mutual Assurance Society of Virginia* v. *Commissioner*, 505 F.2d 128 (1974).

ing of the petition in this case, has not even sought review by this Court), it appears plausible that the taxpayer may have had little incentive to pursue the matter vigorously on appeal. It may well be that when a taxpayer within the jurisdiction of the Fourth Circuit has enough financial involvement to justify rearguing the question at greater length, that court may be persuaded to follow the views of the majority.

Respondent places great weight on the decision by the United States Tax Court on this issue. The Tax Court has been deemed by this Court to be an expert tribunal for the resolution of technical tax issues, *McDonald* v. *Commissioner*, 323 U.S. 57 (1944); *Dobson* v. *Commissioner*, 320 U.S. 489 (1943). Moreover, the opinion of the Tax Court on this issue appears to be, in retrospect, the best and most workmanlike opinion yet rendered on the question. Even the United States agrees in its petition in this case that the Tax Court's opinion ". . . contains the most detailed statement in support of the court below" (Pet. 6). Respondent submits that the opinion of the Tax Court, as affirmed by the First, Eighth, and Ninth Circuits, should be permitted to stand as a uniform interpretation of the applicable statutes by a national court, at least until a real conflict has developed in the Fourth Circuit, or elsewhere, in a case maintained by taxpayer with enough financial interest in the issue to assure a vigorous presentation of the taxpayer's side of the case. Not before then should this Court feel it necessary to apply its time and energies to the resolution of this minor computational issue.

Considering the relative unimportance of the tax question here presented and the degree of unanimity among the authorities which have given that question thorough consideration, this case is but another example of the government's carrying to an absurd degree its unwillingness

to accept defeat with good grace. Justice Douglas warned of this when he stated in his concurrence to *Commissioner* v. *Lester*, 366 U.S. 299, 307 (1961), that "[r]esort to litigation, rather than to Congress, for a change in the law is too often the temptation of government which has a longer purse and more endurance than any taxpayer." See also his dissents in *Knetsch* v. *U. S.*, 364 U.S. 361, 371 (1960) and *U. S.* v. *Skelly Oil Company*, 394 U.S. 678, 687 (1969). This Court, should it grant the premature consideration of the issue requested by the United States, would only encourage further this long-standing and widely-deplored policy of the government, which will continue to be pursued in costly general engagements with taxpayers without regard to the real significance of the issues being litigated.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

RUSSELL W. BAKER
Counsel for Respondent

Of Counsel:

WATSON, ESS, MARSHALL & ENGGAS

Supreme Court, U. S.
FILED
JUN 12 1975

No. 74-799

In the Supreme Court of the United States

OCTOBER TERM, 1974

UNITED STATES OF AMERICA, PETITIONER

v.

FOSTER LUMBER COMPANY, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE UNITED STATES

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INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes and regulations involved	2
Statement	3
Summary of argument	6
Argument:	
Section 172(b)(2) requires that when a taxpayer carries back a net operating loss to a year in which it has both ordinary income and capital gains, the loss deduction available for carryover to a succeeding year is the amount by which the loss exceeds the taxpayer's "taxable income"—ordinary income plus capital gains—for the prior year	11
A. Introduction	11
B. The language and structure of Section 172 demonstrate that respondent did not have available a loss carryover to 1967 because its loss carryback to 1966 did not exceed its taxable income for that prior year	17
C. Respondent did not have a loss carryover from 1966 to 1967 because it would have had no "net operating loss" for 1966 within the meaning of Section 172(c) had the loss been sustained in that earlier year	28
Conclusion	34
Appendix	35

578-088—75—1

CITATIONS

Cases:

	Page
Axelrod v. *Commissioner*, 507 F. 2d 884	22, 26, 27
Burnet v. *Sanford & Brooks Co.*, 282 U.S. 359	12
Chartier Real Estate Co. v. *Commissioner*, 52 T.C. 346, affirmed *per curiam*, 428 F. 2d 474	8, 11, 23, 24, 25, 26, 30, 31, 32, 33, 34
Commissioner v. *Idaho Power Co.*, 418 U.S. 1	32
Commissioner v. *Korell*, 339 U.S. 619	24
Continental Equities, Inc. v. *Commissioner*, 33 T.C.M. 812, appeal pending, C.A. 5, No. 75-1562	23
Crane v. *Commissioner*, 331 U.S. 1	9, 24
Data Products Corp. v. *United States*, C.A. 9, No. 74-3341, decided December 27, 1974, petition for certiorari pending, No. 74-996	23
Gadlow, Estate of v. *Commissioner*, 50 T.C. 975	31
Hanover Bank v. *Commissioner*, 369 U.S. 672	24
Kaecker v. *Commissioner*, 30 T.C. 897	31
Libson Shops, Inc. v. *Koehler*, 353 U.S. 382	12
Little v. *Commissioner*, 294 F. 2d 661	31
Lone Manor Farms, Inc. v. *Commissioner*, 61 T.C. 436	33
Mutual Assurance Society of Virginia Corp. v. *Commissioner*, 505 F. 2d 128	6, 7, 11-12, 13, 21-22, 25, 27, 30
Naegele v. *United States*, D. Minn., decided August 6, 1973, appeal pending, C.A. 8, No. 73-1921	23
Olympic Foundry Co. v. *United States*, 493 F. 2d 1247	23
Payne v. *United States*, 489 F. 2d 1404	31
Redpath v. *Commissioner*, 19 T.C. 470	31
Reo Motors v. *Commissioner*, 338 U.S. 442	29
Weil v. *Commissioner*, 23 T.C. 424, affirmed, 229 F. 2d 593	30, 31, 32

Statutes and regulations:

	Page
Act of February 24, 1919, c. 18, Sec. 204, 40 Stat. 1060	12-13
Act of June 16, 1933, c. 90, Sec. 218(a), 48 Stat. 209	13
Act of June 29, 1939, c. 247, Sec. 211, 53 Stat. 867	13
Act of September 23, 1950, c. 994, Sec. 215, 64 Stat. 937	25
Internal Revenue Code of 1954 (26 U.S.C.):	
Secs. 1-1388	10, 28
Secs. 1-1564	18
Sec. 3	18
Sec. 4	18
Sec. 11	2, 3, 4, 8, 14, 15, 19, 33, 35
Sec. 11(a)	14, 35
Sec. 11(b)	14, 35
Sec. 11(c)	14, 35
Sec. 11(d)	14, 35
Sec. 56	18
Sec. 61	27
Sec. 61(a)	7, 18
Sec. 61(a)(2)	18
Sec. 61(a)(3)	18
Sec. 63	2, 36
Sec. 63(a)	7, 8, 18, 20, 21, 23, 27, 36
Sec. 161	18, 32
Sec. 165	25
Sec. 170	18
Sec. 172	2, 6, 9, 11, 12, 13, 16, 17, 18, 24, 25, 26, 27, 36
Sec. 172(a)	25, 36
Sec. 172(b)	36
Sec. 172(b)(1)	9, 13, 25, 26, 28, 36

Statutes and regulations—Continued

	Page
Sec. 172(b)(2)	5, 6, 7, 8, 9, 11, 17, 18, 19, 20, 21, 23, 24, 25, 26, 33, 37
Sec. 172(c)	9, 10, 17, 25, 27, 28, 32, 38
Sec. 172(d)	18, 38
Sec. 172(d)(1)	25, 38
Sec. 172(d)(2)	26, 38
Sec. 211	18
Sec. 242	18
Sec. 243	18
Sec. 244	18
Sec. 245	18
Sec. 246(b)	18
Sec. 247	13
Sec. 267	25
Sec. 381(c)(1)	26
Sec. 381(c)(3)	26
Sec. 382(b)(4)	26
Sec. 593(b)(2)	18
Sec. 832(a)	18
Sec. 852(b)(2)	18
Sec. 922	18
Sec. 1091	25
Sec. 1201	2, 3, 4, 11, 12, 16, 33, 38
Sec. 1201(a)	4, 8, 9, 14, 15, 19, 20, 22, 23, 26, 27, 29, 38
Sec. 1201(b)	22, 27, 39
Sec. 1202	2, 26, 27, 39
Revenue Act of 1918, c. 18, 40 Stat. 1057, Sec. 204(b)	12
Treasury Regulations on Income Tax (26 C.F.R.):	
§ 1.172-4(b)(1)	2, 6, 19, 40
§ 1.172-5(a)(1)	2, 19, 40-41
§ 1.172-5(a)(3)	2, 19, 41

Miscellaneous:

	Page
Branda, *Net Operating Losses and Capital Gains—Some Bizarre Consequences of the Alternative Tax Computation*, 28 Tax Lawyer 455 (1975)	25
Hawkins, *Mechanics of Carrying Losses to Other Years*, 14 West. Res. L. Rev. 241 (1963)	25
Herwitz, *Business Planning—Materials on the Planning of Corporate Transactions* 844 (1966)	25
H. R. Rep. No. 855, 76th Cong., 1st Sess. (1939)	29
5 Mertens, *Law of Federal Income Taxation* (Rev.):	
c. 29	13
§ 29.01	13
§ 29.02	21
Recent Cases, 8 San Diego L. Rev. 442 (1971)	25
Significant Development, 55 Boston Univ. L. Rev. 134 (1975)	25
1 Surrey, Warren, McDaniel and Ault, *Federal Income Taxation, Cases and Materials* (1972 ed.)	13

In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-799

UNITED STATES OF AMERICA, PETITIONER

v.

FOSTER LUMBER COMPANY, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The memorandum and order of the district court, and the stipulation of facts to which it refers (Pet. App. A 1a–7a) are not reported. The opinion of the court of appeals (Pet. App. B 8a–14a) is reported at 500 F. 2d 1230.

JURISDICTION

The judgment of the court of appeals was entered on July 29, 1974 (Pet. App. C 15a–16a). On October 17, 1974, Mr. Justice Blackmun extended the time for filing a petition for a writ of certiorari to and including December 26, 1974. The petition for a writ

of certiorari was filed on December 24, 1974, and was granted on March 31, 1975 (A. 21). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Section 172 of the Internal Revenue Code of 1954 permits the carryback of a net operating loss to a taxable year prior to the year in which the loss is sustained, and a carryover to a succeeding year of the amount, if any, by which the loss exceeds the taxable income for each prior year to which the loss may be carried.

The question presented is whether, in carrying back a net operating loss to a year in which the taxpayer had both ordinary income and capital gains and employed the alternative tax computation method of Section 1201, the loss deduction available for carryover to a succeeding year is the amount by which the loss exceeds the taxpayer's taxable income (ordinary income plus capital gains) for the prior year, or, as the decision below held, the amount by which the loss exceeds only the ordinary income for the prior year.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 11, 63, 172, 1201 and 1202 of the Internal Revenue Code of 1954, and of the Treasury Regulations on Income Tax, Sections 1.172–4(b)(1)(ii) and 1.172–5(a) (1) and (3), are set forth in the Appendix, *infra*.

BEST COPY AVAILABLE

STATEMENT

Respondent is in the lumber business (Pet. App. A 4a).[1] For its taxable years ended March 31, 1966 through July 19, 1968, it reported the following amounts of ordinary income and capital gains (Pet. App. A 4a):

Taxable year	Net ordinary income	Excess of net long-term capital gain over net short-term capital loss	Total taxable income or loss
1966	$7,236.05	$166,634.81	$173,870.86
1967	114,261.82	114,655.96	228,917.78
1968	(42,203.12)	----------	(42,203.12)

Because respondent sustained a net operating loss of $42,203.12 for its taxable year 1968, it carried back that loss to 1966 and recomputed its tax liability for that earlier year. Accordingly, respondent filed Form 1139 (Corporation Application for Tentative Refund from Carryback of Net Operating Loss). As the Code prescribes, respondent recomputed its tax liability for 1966 under the method provided by section 11 (the so-called "regular method"), and the "alternative tax computation" provided by Section 1201 of the Code. Taking into account the carryback of the 1968 net operating loss of $42,203.12, respondent's computations of its 1966 income tax liability under each of the two methods were as follows (Pet. App. A 5a):

[1] The parties submitted the case to the district court on a stipulation of facts (Pet. App. A 3a–7a).

578—088—75——2

"Regular Method" (Section 11)

Taxable Income (excluding net operating loss deduction):		
Ordinary Income	$7,236.05	
Capital Gains Income	166,634.81	
		$173,870.86
LESS: Net Operating Loss Deduction Resulting From Carryback of 1968 Net Operating Loss		(42,203.12)
Taxable Income (Section 63(a))		$131,667.74
Regular Tax (1966 rates)		$ 58,200.52

"Alternative Method" (Section 1201)

Taxable Income (excluding net operating loss deduction):		
Ordinary Income	$7,236.05	
Capital Gains Income	166,634.81	
		$173,870.86
LESS: Net Operating Loss Deduction Resulting From Carryback of 1968 Net Operating Loss		(42,203.12)
Taxable Income (Section 63(a))		$131,667.74
(Step 1—Partial Tax)		
LESS: Excess of Net Long-Term Capital Gain Over Net Short-Term Capital Loss		$166,634.81
Balance		($ 34,967.07)
Partial Tax at Section 11 Rates on Balance (Section 1201(a)(1))		-0-
(Step 2—Capital Gains Tax)		
PLUS: Capital Gains Tax at Flat 25 Percent Rate on Excess of Net Long-Term Capital Gain Over Net Short-Term Capital Loss (Section 1201(a)(2))		$ 41,658.70
Alternative Tax (Sum of Partial Tax and Capital Gains Tax) (1966 rates)		$ 41,658.70

Since the $41,658.70 tax computed under the "alternative method" of Section 1201 was lower than the $58,200.52 tax computed under the "regular method" of Section 11, respondent was required to, and did, report the amount of alternative tax computed under the provisions of Section 1201 as its recomputed 1966 tax liability (Pet. App. A 4a–5a).

This suit involves respondent's tax liability for its taxable year ended March 31, 1967, the year immediately following the earliest year to which the 1968 net operating loss had been carried back. In applying for a tentative refund from the carryover of a net operating loss to that year, respondent claimed that $34,967.07 of its total 1968 loss of $42,203.12, which had been carried back to 1966, was still available to offset income for 1967. Respondent based its claim on the contention that its 1968 loss had been "used" in 1966 only to the extent of its ordinary income of $7,236.05 for that year (Pet. App. A 6a).

On audit, the Commissioner of Internal Revenue disallowed respondent's claim for refund for its taxable year 1967 (Pet. App. A 7a). The Commissioner's disallowance was premised on the terms of Section 172(b)(2), the statute governing the carryover and carryback of net operating losses. That statute provides that the portion of the loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of the loss over the sum of the "taxable income" for each of the prior taxable years to which such loss may be carried. Since respondent's 1968 net operating loss of $42,203.12 was less than its 1966 taxable income of $173,870.86, the Commissioner determined that respondent's 1968 net operating loss had been entirely "used" to offset its taxable income for 1966. As a result, no part of the 1968 net operating loss deduction was available to respondent to carry forward from its taxable year 1966 to 1967.

The district court upheld respondent's claim for refund (Pet. App. A 1a–3a) and the court of appeals

affirmed (Pet. App. B 8a–14a). In concluding that respondent still had $34,967.07 of its 1968 loss available to offset income for 1967, the court of appeals acknowledged that "its interpretation of section 172 (b)(2) is counter to the position announced in Treasury Regulation 1.172–4(b)(ii) * * *" (Pet. App. B 11a). However, the court of appeals was strongly influenced by the fact that the courts that had then considered the issue had rejected the government's position. It therefore concluded that it could not "dismiss lightly the cumulative weight of our fellow judges' decisions or the divisiveness and administrative confusion that a contrary conclusion at this point might foster" (Pet. App. B 13a–14a). Shortly thereafter, however, the Fourth Circuit upheld the government's position in *Mutual Assurance Society of Virginia Corp.* v. *Commissioner,* 505 F. 2d 128.

SUMMARY OF ARGUMENT

During its taxable years 1966–1968, respondent had the following income and losses:

1966	$173,870.86
1967	228,917.78
1968	(42,203.12)

In accordance with the highly detailed provisions of Section 172 of the Internal Revenue Code, which govern the carryback and carryover of net operating losses, respondent "carried back" its 1968 loss to 1966. The question presented, upon which the courts of appeals have divided, is the correct amount, if any, of the 1968 loss remaining for "carryover" to offset respondent's taxable income for 1967. We submit that

respondent had no loss carryover available to 1967 because its taxable income for 1966 exceeded the amount of its 1968 loss. Thus, the 1968 loss was completely "absorbed" upon its carryback to 1966 and there was no remaining portion of that loss available for carryover to 1967. The Fourth Circuit has so held on parallel facts in *Mutual Assurance Society of Virginia Corp.* v. *Commissioner,* 505 F. 2d 128.

The decision below held, however, that the $42,203.12 loss was only "absorbed" to the extent of respondent's ordinary income for 1966—$7,236.05. It thereby concluded that respondent had a $34,967.07 ($42,203.12 less $7,236.05) loss carryover available to offset its income for 1967.

1. The decision below contravenes the explicit terms of Section 172(b)(2), which governs this case. That provision states that the amount of a loss carryover in these circumstances is "the excess, if any, of the amount of such loss over the sum of the *taxable income* for each of the prior taxable years to which such loss may be carried" (emphasis supplied). The term "taxable income" as used in Section 172(b)(2) is defined by Section 63(a) of the Code to mean "gross income, minus the deductions allowed by this chapter * * *." Under this definition, "taxable income" encompasses "all income from whatever source derived" (see Section 61(a)), which would include both ordinary income and capital gains.

Here, it is undisputed that respondent's 1966 taxable income was $173,870.86, the sum of its net ordinary income and capital gains. Since its 1968 loss of $42,203.12 was less than its 1966 taxable income of $173,870.86, there was no "excess" of the loss over taxable income to

be carried over to 1967. Thus, under Section 172(b)(2) respondent had no loss carryover from 1966 to 1967.

Contrary to the decision below, the fact that respondent employed the Section 1201(a) alternative tax computation for 1966 does not call for a different result. That provision permitted respondent to compute its 1966 tax as the sum of (1) a "partial" tax at the regular Section 11 rates imposed on its taxable income less net long-term capital gains; and (2) a flat 25 percent tax on its net long-term capital gains. But the particularized "partial" tax computation does not alter the meaning of "taxable income" as that term is defined in Section 63(a) and used in Section 172 (b)(2). Whether the alternative or the regular tax computation is applicable for the carryback year, a corporation's "taxable income" continues to be its gross income—which would include both its ordinary income and long-term capital gains—less allowable deductions. Indeed, the first mathematical operation of the computation prescribed by Section 1201(a)—the subtraction of the 1968 loss of $42,203.12 from the taxable income of $173,870.86, to yield a recomputed taxable income of $131,667.74—demonstrates that no part of the loss remained to offset income by carryover to 1967.

2. The only detailed judicial exposition in support of respondent's position is the secondary holding of the Tax Court in *Chartier Real Estate Co.* v. *Commissioner,* 52 T.C. 346, 356–358, affirmed *per curiam,* 428 F. 2d 474 (C.A. 1). There, the Tax Court concluded that the last phrase of Section 172(b)(2), "to which such loss may be carried," modifies the phrase

"taxable income" as well as the words "prior taxable years." Under that analysis, the only taxable income for the prior year to which the net operating loss is carried is the $7,236.05 of ordinary income upon which the "partial" tax of Section 1201(a) would have been computed in the absence of the loss carryback. In the Tax Court's view, a loss carryback is only "used" to the extent it reduces the Section 1201(a) partial tax base and affects the alternative tax computation for the prior year.

The Tax Court's construction construes Section 172 (b)(2) as if it read "* * * the sum of the taxable income [to which such loss may be carried] for each of the prior years to which such loss may be carried." In the absence of any legislative history warranting such a strained construction, its use hardly comports with this Court's oft-repeated admonition that "the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses." *Crane* v. *Commissioner,* 331 U.S. 1, 6.

Moreover, the Tax Court's construction is contrary to the usage employed by Section 172 and by the Code generally, in which a loss is "deducted" from income and not "carried" to taxable income. On the other hand, the term "carried" has always borne a temporal connotation of a transfer of a loss from the year in which it occurred to another year.

3. The error of the decision below is also illustrated by the fact that it permitted respondent to carry over a loss from 1966 to 1967 even though it would have had no "net operating loss" for 1966, as that term is defined by Section 172(c), if the loss had been sus-

tained in that earlier year. Section 172(b)(1) provides that a "net operating loss" for a particular year shall be a "net operating loss carryback" to prior years or a "net operating loss carryover" to succeeding years. Without a "net operating loss", there can be no carryback or carryover.

But under Section 172(c), a net operating loss is "the excess of the deductions allowed by this chapter [Sections 1–1388] over the gross income." There would have been no "excess" of deductions ($42,203.12) over gross income ($173,870.86) for 1966 within the meaning of Section 172(c) which would have qualified as a net operating loss carryover to 1967. The result should be the same here where the 1968 loss is taken into account in computing respondent's 1966 tax liability. After the carryback of that loss, respondent had no "excess" of deductions over gross income. Indeed, this statutory analysis is confirmed by the congressional understanding that no net operating loss deduction can be carried from a year in which the taxpayer does not suffer a loss.

Finally, the decision below permits a loss to offset income in another taxable year when that loss could not be used to offset the income of the year in which the loss was sustained, if the alternative tax computation were applicable. For example, if respondent incurred its $42,203.12 operating loss in 1966 instead of 1968, it could not offset it against its capital gains which were subject to the flat 25 percent tax. That rule was judicially established more than 20 years ago and is not challenged here.

If respondent could not have used the $42,203.12 loss in 1966 to offset its capital gains and thereby reduce its effective tax rate, it would be anomalous to allow it to carry such a loss forward to 1967 and possibly beyond, for use in offsetting income subject to a higher effective tax rate. Without an explicit congressional direction, the Code should not be construed to allow the very pyramiding of the benefits of the net operating loss carryback deductions and the alternative tax computation that is unavailable if the loss and capital gains occurred in a single taxable year.

ARGUMENT

SECTION 172(B)(2) REQUIRES THAT WHEN A TAXPAYER CARRIES BACK A NET OPERATING LOSS TO A YEAR IN WHICH IT HAS BOTH ORDINARY INCOME AND CAPITAL GAINS, THE LOSS DEDUCTION AVAILABLE FOR CARRYOVER TO A SUCCEEDING YEAR IS THE AMOUNT BY WHICH THE LOSS EXCEEDS THE TAXPAYER'S "TAXABLE INCOME"—ORDINARY INCOME PLUS CAPITAL GAINS—FOR THE PRIOR YEAR

A. INTRODUCTION

The question presented in this federal income tax case is technical and computational in character. It involves the operation of the provisions of the Internal Revenue Code governing the carryback and carryover of net operating losses (Section 172) and those prescribing the computation of the alternative tax on capital gains (Section 1201). While each of these two statutory provisions has been separately applied without judicial disagreement, the courts of appeals have divided on the question of the amount of a net operating loss deduction available for carryover to a succeeding year after the carryback of a loss to a prior

578—088—75——3

year in which the taxpayer employs the alternative tax computation method of Section 1201.

The decision below held, in conformity with *Chartier Real Estate Co.* v. *Commissioner,* 52 T.C. 346, 356–358, affirmed *per curiam,* 428 F. 2d 474 (C.A. 1), that the amount of the loss carryover available is the excess of the loss carryback over the ordinary income of the prior year. We submit that the contrary result reached by the Fourth Circuit in *Mutual Assurance Society of Virginia Corp.* v. *Commissioner,* 505 F. 2d 128, correctly concluded that the amount of the loss carryover in these circumstances is the amount by which the loss carryback exceeds the ordinary income *and* net long-term capital gains of the prior year.

Before determining how Sections 172 and 1201 operate together in the context of this case, it is appropriate to consider first the circumstances under which they individually apply. Under the annual system of accounting upon which our income tax system is based, income and deductions must be reported with respect to a discrete taxable year. It is therefore possible for a taxpayer to sustain an economic loss over a period longer than a single taxable year and still bear a tax liability for a particular profitable taxable year falling within the longer loss period. See *Burnet* v. *Sanford & Brooks Co.,* 282 U.S. 359.

The statutory mechanism for the carryback and carryover of losses is intended to mitigate the impact of the annual system of accounting. As this Court observed in *Libson Shops, Inc.* v. *Koehler,* 353 U.S. 382, 386, the net operating loss carryover and carryback provisions "were enacted to ameliorate the

unduly drastic consequences of taxing income strictly on an annual basis. They were designed to permit a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year."[2]

The rules governing the carryover and carryback of net operating losses are set forth in Section 172 of the 1954 Code, Appendix, *infra,* pp. 36–38. That statute permits a net operating loss to be carried back to offset the income of the third taxable year preceding the year in which the loss is sustained. Section 172(b)(1)(A). To the extent that such a loss exceeds the taxable income of the preceding three years so that it is not earlier consumed, the remaining portion is available to be carried forward to each of

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[2] The first provision permitting the excess of expenses over income in one tax year to be deducted in another tax year was Section 204(b) of the Revenue Act of 1918, which permitted a one-year carryover and carryback. See Act of February 24, 1919, c. 18, Sec. 204, 40 Stat. 1060. In 1933, the National Industrial Recovery Act abolished all net operating loss carryovers and carrybacks. See Act of June 16, 1933, c. 90, Sec. 218(a), 48 Stat. 209. In 1939, a net operating loss carryover provision was reintroduced and provided for a two-year carryover. See Act of June 29, 1939, c. 247, Sec. 211, 53 Stat. 867.

Thus, the period of the carryback and carryover has ranged from the one-year carryback and one-year carryover permitted in 1918 to the three-year carryback and five-year carryover permitted since 1958. See 5 Mertens, *Law of Federal Income Taxation (Rev.),* § 29.01. The content and computation of the net operating loss deduction have varied both in concept and in detail. See, generally, 5 Mertens, *supra,* at c. 29; 1 Surrey, Warren, McDaniel and Ault, *Federal Income Taxation, Cases and Materials* 769–773 (1972 ed.). See also *Mutual Assurance Society of Virginia Corp.* v. *Commissioner,* 505 F. 2d 128, 136–138 (C.A. 4).

the five taxable years following the years in which the loss is sustained. Section 172(b)(1)(B). A net operating loss must be carried back to the earliest possible year to which it may be carried. Section 172(b)(1)(A).[3]

Section 1201(a) of the 1954 Code, Appendix, *infra*, pp. 38–39, is the second provision that comes into play in this case. That statute prescribes a so-called "alternative tax" for corporations on the excess of

[3] The operation of the loss carryover and carryback provision can be illustrated by the following example. Suppose a taxpayer has taxable income and losses for the period 1961–1969, as follows:

1961	$10
1962	10
1963	10
1964	(100)
1965	10
1966	10
1967	10
1968	10
1969	40

After the carryback of the 1964 loss to the years 1961–1963, the taxpayer would have consumed $30 of the $100 loss and would have available a $70 loss carryover to the five years succeeding 1964. That carryover would offset the total income for each of the years 1965–1968 and $30 of the income for 1969. The recomputed net income figures for the years 1961–1969, would be as follows:

1961	0
1962	0
1963	0
1964	0
1965	0
1966	0
1967	0
1968	0
1969	$10

the net long-term capital gains over the net short-term capital losses. This alternative tax is an exception to the general income tax imposed upon corporations by Section 11 of the Code, Appendix, *infra*, pp. 35–36.[4] As Section 1201(a) provides, the alternative tax is in "lieu of the tax imposed by sections 11 * * * (if such tax is less than the tax imposed by such sections) * * *." Thus, if a corporation has income from capital gains, it is required to compute its tax under both Sections 11 and 1201(a) and employ whichever method yields the lower liability.

The mechanics of the Section 1201(a) alternative tax computation involves a two-step process. First, a partial tax is computed on the taxable income reduced by the net long-term capital gains[5] at the regular corporate rates imposed by Section 11 (effectively leaving the ordinary income[6] subject to the partial tax). Secondly, a 25 percent tax is imposed on the net long-term capital gains. The alternative tax is the sum of the partial tax and the 25 percent tax on long-term capital gains. Thus, if a corporation had net long-term capital gains sufficiently in excess of $25,000,

[4] Pursuant to Section 11 (a), (b), (c), and (d), the corporate income tax rate during the period at issue was 22 percent of the first $25,000 of taxable income and 48 percent of the excess over $25,000.

[5] For purposes of simplicity, we use the term "net long-term capital gain" rather than the statutory phrase "excess of net long-term capital gain over net short-term capital loss."

[6] Strictly speaking, the Section 1201(a) "partial" tax base is taxable income less the excess of net long-term capital gains over net short-term capital losses. That base would therefore include short-term capital gains. However, because respondent had no short-term capital gains for 1966, we have referred to

which would be taxed at the regular 48 percent rate, it would be required to use the alternative tax.[7]

In this case, respondent sustained a net operating loss of $42,203.12 in 1968 and carried that loss back to 1966. Neither the amount of that loss nor its eligibility for carryback treatment is in dispute. What is at issue is the amount, if any, of the loss available for carryover to 1967. That amount depends upon how much of the 1968 loss was consumed to offset respondent's 1966 income, a year in which respondent employed the alternative tax computation of Section 1201.

Thus, the dispute focuses upon the mechanics of applying both the net operating loss carryback provisions of Section 172 and the alternative tax computation of Section 1201 for respondent's taxable year 1966. During that year, respondent received $7,236.05 of ordinary income and $166,634.81 of net long-term capital gains, for a total taxable income of $173,870.86.

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the Section 1201(a) partial tax base as imposed on "ordinary income".

[7] During the period at issue, the alternative tax would have been equal to the regular tax if the corporation had $28,260 of net long-term capital gains and no ordinary income. Under both methods, the tax would have been $7,065. Thus, assuming no ordinary income, the alternative tax would only be lower if the net long-term capital gains exceeded $28,260. That latter figure is derived from the following formula, where x equals the net long-term capital gains: $.25x = .22(25{,}000) + .48(x - 25{,}000)$. If a corporation has $25,000 of ordinary income so that each additional dollar of income would be taxed at the 48 percent rate, the 25 percent alternative tax would always yield a lower liability in the event it has any long-term capital gains.

Respondent contends, and the decision below held, that the $42,203.12 loss for 1968 was consumed in 1966 only to the extent of its ordinary income for that latter year, $7,236.05. If the 1968 loss were consumed only to this limited extent in its carryback to 1966, then respondent would still have a loss carryover of $34,967.07 ($42,203.12 less $7,236.05) available to offset income for 1967.[8]

However, we submit that respondent's 1968 loss of $42,203.12 was completely consumed upon its carryback to 1966 because its taxable income for that year—$173,870.86—far exceeded the amount of the carryback loss. As a result, there was no loss available for carryover to respondent's taxable year 1967. In our view, this result is explicitly mandated by the terms of Section 172(b)(2) and confirmed by the definition of "net operating loss" in Section 172(c). These statutory provisions, to which we now turn, demonstrate that respondent's 1968 loss was entirely consumed in its carryback to 1966.

B. THE LANGUAGE AND STRUCTURE OF SECTION 172 DEMONSTRATE THAT RESPONDENT DID NOT HAVE AVAILABLE A LOSS CARRYOVER TO 1967 BECAUSE ITS LOSS CARRYBACK TO 1966 DID NOT EXCEED ITS TAXABLE INCOME FOR THAT PRIOR YEAR

1. (a) The critical Code provision governing the amount, if any, of respondent's loss carryover to 1967 is Section 172(b)(2). That section, entitled "Amount of

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[8] Respondent had $114,261.82 of ordinary income and $114,655.96 of net long-term capital gains for 1967 (Pet. App. A 4a). Hence, there is no possibility that any portion of the 1968 loss would be available for carryover to years subsequent to 1967.

carrybacks and carryovers.—", states in pertinent part:

> The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried.

Thus, the amount of the net operating loss which may be carried over to succeeding years is the excess of the amount of the loss over the taxpayer's "taxable income" for the earliest year to which the loss is carried back.

The term "taxable income" is itself precisely defined in the Code. Section 63(a), Appendix, *infra,* p. 36, provides that 'taxable income" "means gross income, minus the deductions allowed by this chapter * * *." Under this definition, which is fully applicable to Section 172(b)(2),[9] "taxable income"

[9] The specific language of Section 63(a) applies its definition of "taxable income" to all sections of the Code contained in Subtitle A, which includes the provisions from Section 1 to and including 1564.

That the Section 63(a) definition is applicable to Section 172(b)(2) is further demonstrated by the use of the term "taxable income" in many other Code provisions. See, *e.g.*, Sections 3, 4, 56, 161, 170, and 211. Indeed, when Congress intended that the term "taxable income" was to depart from the Section 63(a) definition, it included an explicit modification. See, *e.g.*, Sections 593(b)(2)(E) (mutual savings banks), 832(a) (insurance companies), and 852(b)(2) (regulated investment companies).

The only modifications to "taxable income" contained within Section 172 are set forth in Section 172(b)(2)(B) (requiring the exclusion of the net operating loss for the current loss year

encompasses "all income from whatever source derived" (see Section 61(a)), which would include both ordinary income and long-term capital gains.[10]

It is undisputed that respondent's 1966 taxable income, as that term is defined by Section 63(a), was $173,870.86, the sum of its net ordinary income and long-term capital gains. Since its 1968 loss of $42,203.12 was less than its 1966 taxable income of $173,870.86, there was no "excess" of the loss over taxable income to be carried over to 1967.[11] Thus, the language of Section 172(b)(2) shows that respondent had no loss carryover from 1966 to 1967. Accord: Treasury Regulations on Income Tax, §§ 1.172–4(b)(1)(ii) and 1.172–5(a)(1) and (3) (26 C.F.R.), Appendix, *infra,* pp. 40–44.

The fact that respondent employed the Section 1201(a) alternative tax computation for 1966 does not permit a different result. That provision required respondent to compute its 1966 tax as the sum of (1) a "partial" tax at the regular Section 11 rates imposed on its taxable income less long-term capital gains; and

or any other year thereafter) and Section 172(d) (which applies only to corporations eligible for the special deductions under Sections 242 and 922 and the computations allowed by Sections 243, 244, 245, 246(b), and 247 of the Code). None of these departures from the Section 63(a) definition of "taxable income" is applicable here.

[10] The definition of gross income, as set forth in Section 61(a), is all-inclusive and encompasses gross income derived from business and gains derived from dealings in property. See Sections 61(a)(2), (a)(3).

[11] We discuss the effect of the final statutory phrase "to which such loss may be carried" at pp. 23–26, *infra.*

578—088—75——4

(2 a 'capital gains" tax imposed at a flat 25 percent rate on the previously excluded capital gains. Thus, before taking the 1968 loss carryback into account, respondent's 1966 tax was the sum of (1) the Section 11 "partial" tax on $7,236.05 ($173,870.86 less $166,634.81); and (2) 25 percent of $166,634.81.

In holding that respondent had available a $34,-967.07 loss eligible for carryover to 1967, the decision below concluded that the proper computation for 1966 was to net the 1968 loss of $42,203.12 only against respondent's 1966 ordinary income of $7,236.05, because the Section 1201(a) "partial" tax would have been imposed only on the ordinary income segment of respondent's taxable income. But the particularized "partial" tax computation of Section 1201(a) does not alter the meaning of "taxable income" as that term is defined in Section 63(a) and used in Section 172(b)(2). Whether the alternative or the regular tax computation is applicable, a corporation's "taxable income" continues to be its gross income (less allowable deductions) which would include both ordinary income and capital gains. The court of appeals' restriction of "taxable income" to ordinary income is contrary to the definition of that term in Section 63(a).

Thus, even though respondent used the Section 1201(a) alternative tax computation, its "taxable income" for 1966 continued to equal $173,870.86, in conformity with the definition of that term in Section 63(a). Since the $42,203.12 loss for 1968 was less than respondent's 1966 taxable income of $173,870.86, that loss was completely "absorbed" upon its carryback

to that prior year. Indeed, the first mathematical operation of the computation prescribed by Section 1201(a)—the subtraction of the 1968 loss of $42,203.12 from respondent's 1966 taxable income of $173,870.86, which reduced its taxable income for that year to $131,667.74—demonstrates that no part of the loss remained to offset income by carryover to 1967. See p. 4, *supra*. There was accordingly no "excess * * * of the amout of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried" within the meaning of Section 172(b)(2).

(b) Moreover, Section 172(b)(2) itself demonstrates that the term "taxable income" cannot be subjected to inferred modifications such as the subtraction of net long-term capital gains that the court of appeals imposed. The very next sentence of Section 172(b)(2) after the quoted portion on page 17, *supra*, begins "For purposes of the preceding sentence, the taxable income for any such prior taxable year shall be computed —" and this clause is followed by several specific and detailed modifications. If the term "taxable income" is to be modified as the court of appeals provided, one would expect that the subtraction of net long-term capital gains from "taxable income" would have received explicit congressional sanction by inclusion in the list of statutory modifications. The absence of such a provision in a statute that is structured with precision and replete with detail strongly suggests that the term "taxable income" in Section 172(b)(2) must be given the meaning set forth in

Section 63(a) for purposes of the entire income tax subtitle.[12]

It was the definition of "taxable income" in Section 63(a) that led the Fourth Circuit in *Mutual Assurance Society of Virginia Corp.* v. *Commissioner, supra,* 505 F. 2d 128, to uphold in an essentially identical case the statutory construction we urge here. More recently, the Sixth Circuit in *Axelrod* v. *Commissioner,* 507 F. 2d 884, has also refused to modify "taxable income" in an analogous case involving an individual taxpayer.

There, the taxpayer carried back a net operating loss to a year in which he had computed his tax liability under the alternative capital gains tax for individuals provided by Section 1201(b). Like Section 1201(a), which is applicable to a corporation, Section 1201(b) involves a two-step calculation in which a partial tax is computed on taxable income reduced by a particular deduction.[13] And like respondent, the tax-

[12] The care and precision with which Congress had delineated the net operating loss carryover and carryback provision leaves little, if any, room for independent inference in construing the statute. As a leading text has stated, "To understand the scope of the permissible net operating loss deduction for a particular taxable year it is necessary to define the terms 'net operating loss,' 'net operating loss carry-back' and 'net operating loss carry-over.' None of these terms may be defined simply, there being certain modifications (which were called exceptions, limitations and adjustments under the 1939 Code and which are called modifications under the 1954 Code), required in order to determine the amount of the loss which may be carried back or carried over and deducted in the taxable year." 5 Mertens, *supra,* § 29.02.

[13] The alternative tax for individuals provided by Section 1201(b), Appendix *infra,* p. 39, is the sum of (1) a partial tax at regular rates on the taxable income reduced by 50 per-

payer in *Axelrod* argued that his net operating loss was only "absorbed" to the extent of the segment of his income subject to the partial tax. However, the court rejected this contention, stating in terms pointedly appropriate to this case, "[t]axable income is the same regardless of the method of computation even though the amount of tax due may be different" (507 F. 2d at 887).[14] Thus, unless expressly modified by another provision of the Code, taxable income means net ordinary income plus net capital gains.

2. The court of appeals in this case did not consider the effect upon Section 172(b)(2) of the definition of "taxable income" in Section 63(a). Instead, it adopted the construction of Section 172(b)(2) formulated by the Tax Court in its secondary holding in *Chartier Real Estate Co.* v. *Commissioner,* 52 T.C. 346, 356–358, affirmed *per curiam,* 428 F. 2d 474 (C.A. 1). There, the Tax Court concluded that the phrase of Section 172(b)(2), "to which * * * such loss may be carried," modifies the phrase "taxable income" as well as the words "prior taxable years." Pursuant to the Tax Court's analysis, which the First Circuit summarily affirmed because it viewed the question as "unimportant and seldom occurring" (428 F. 2d at 475),[15]

cent of the net long-term capital gains; and (2) a flat 25 percent tax on the net long-term capital gains.

[14] In *Axelrod*, the Sixth Circuit expressed agreement with the Fourth Circuit's holding in *Mutual Assurance*. See 507 F. 2d at 888.

[15] The Ninth Circuit has followed *Chartier* in two brief *per curiam* decisions. See *Olympic Foundry Co.* v. *United States*, 493 F. 2d 1247, and *Data Products Corp.* v. *United States*, decided December 27, 1974, No. 74–3341, petition for certiorari pending, No. 74–996. Accord: *Naegele* v. *United States*, decided August 6, 1973

the only taxable income for the prior year to which the net operating loss is "carried" is the $7,236.05 of ordinary income upon which the "partial" tax of Section 1201(a) would have been computed in the absence of the loss carryback. In the Tax Court's view, a loss carryback is only "used" to the extent it reduces the Section 1201(a) partial tax base and affects the alternative tax computation for the prior year.

This construction of Section 172(b)(2) is at odds with the plain meaning of that provision. The critical sentence of Section 172(b)(2) states:

> The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried.

While the final phrase "to which such loss may be carried" modifies the immediately preceding term "prior taxable years,"[16] the Tax Court in *Chartier* held that the final phrase also modifies the words "taxable income." But the Tax Court's construction views the statute as if it reads—"* * * the sum of the taxable income [to which such loss may be carried] for each of the prior taxable years to which such loss may be carried." Such a strained construction hardly comports with this Court's admonition that "the

(D. Minn.), appeal pending, C.A. 8, No. 73–1921; and *Continental Equities, Inc.* v. *Commissioner*, 33 T.C.M. 812, appeal pending, C.A. 5, No. 75–1562.

[16] In parallel fashion, the final phrase "to which * * * such loss may be carried" in the first sentence of Section 172(b)(2) modifies only the immediately preceding term "the earliest of the taxable years."

words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses." *Crane* v. *Commissioner*, 331 U.S. 1, 6. See also *Hanover Bank* v. *Commissioner*, 369 U.S. 672, 687–688; *Commissioner* v. *Korell*, 339 U.S. 619, 627–628.

Indeed, if Congress had intended the final phrase "to which such loss may be carried" to modify "taxable income," one would suppose that the legislative history of Section 172 would have clearly so stated.[17] As the Fourth Circuit observed in *Mutual Assurance Society of Virginia Corp.* v. *Commissioner, supra*, 505 F. 2d at 134, "[i]f Congress had intended to enact the rule in *Chartier Real Estate*, it certainly chose an obscure verbal formula to convey this meaning."[18]

[17] The phrase "to which such loss may be carried" was introduced into Section 172 at the time of the 1954 codification and there is no legislative history explaining its significance. The absence of any special meaning for the phrase led the Fourth Circuit to conclude that it was simply a substitute for the term "intervening years' which was used in the prior statute. Thus, the court concluded that the phrase "to which such loss may be carried" simply served to identify those years whose taxable income must be taken into account in a carryover or carryback computation. See Act of September 23, 1950, c. 994, Sec. 215, 64 Stat. 937. See *Mutual Assurance Society of Virginia Corp.* v. *Commissioner*, *supra*, 505 F. 2d at 134, and n. 10.

[18] Prior to the Tax Court's *Chartier* decision in 1969, the commentators had regarded Section 172(b)(2) as explicit in denying a net operating loss carryover in the circumstances of this case. See Herwitz, *Business Planning—Materials on the Planning of Corporate Transactions* 844 (1966); Hawkins, *Mechanics of Carrying Losses to Other Years*, 14 West. Res. L. Rev. 241, 250–251 (1963). For post-*Chartier* commentary, see *Significant Development*, 55 Boston Univ. L. Rev. 134 (1975); and recent cases, 8 San Diego L. Rev. 442 (1971). But compare Branda, *Net Operating Losses and Capital Gains—Some Bizarre Consequences of the Alternative Tax Computation*, 28 Tax Lawyer 455 (1975).

Moreover, the Tax Court's construction of Section 172(b)(2) is contrary to the overall structure of Section 172. According to the usage of the Code, and of Section 172 specifically, a loss is "deducted" from income; it is not "carried" to taxable income. See Section 172(a), (c), (d)(1). See also Sections 165, 267, and 1091. On the other hand, throughout Section 172, the term "carried" has the temporal connotation of a transfer of a loss from the year in which it occurred, and would normally be taken into account, to another year. For example, Section 172(b)(1)(A) and (b)(1)(B) respectively speak of a loss carryback or a loss carryover "to each of the 3 taxable years preceding the taxable year of such loss" and "to each of the 5 taxable years following the taxable year of such loss." See Sections 172(b)(1)(C), (D), (E), (b)(2) (first sentence), 381(c)(1), (3), and 382(b)(4). Accord: *Axelrod* v. *Commissioner, supra,* 507 F. 2d at 887, n. 2.

The decision below therefore erred in holding that respondent's net operating loss of $42,203.12 was selectively "carried" back to the $7,236.05 segment of ordinary income upon which its "partial" Section 1201(a) alternative tax would have been computed. That loss was "carried" back as a whole to the year 1966. It therefore had to be offset against the total amount of taxable income for that prior year rather than against a particular type of income received in that year. Since respondent's taxable income for 1966 ($173,870.86) exceeded its 1968 loss ($42,203.12), the loss was completely "absorbed" upon its carryback to 1966.

3. Finally, the structure of Section 172 provides

a further indication that the *Chartier* modification of "taxable income" adopted by the decision below is erroneous. In the case of a taxpayer other than a corporation, Section 172(d)(2)(B) states that in computing the taxable income for any prior year, "the deduction for long-term capital gains provided by section 1202 shall not be allowed." Section 1202, Appendix, *infra,* p. 39, permits a deduction of 50 percent of net long-term capital gains and is available only to non-corporate taxpayers. Thus, in computing the "taxable income" of a non-corporate taxpayer for a year to which a net operating loss is carried, Section 172(d)(2)(B) requires that, if the taxpayer has claimed the Section 1202 deduction, the full amount of ordinary income plus capital gains will be offset against the net operating loss.

If the decision below were correct in holding that the term "taxable income" means only ordinary income in the case where the alternative tax is applicable, Section 172 would accord markedly better treatment for corporations than individuals. An individual who claimed the Section 1202 deduction for 50 percent of his capital gains would be required to restore that amount to "taxable income" in computing a net operating loss carryover. Similarly, under *Axelrod* v. *Commissioner,* 507 F. 2d 884 (C.A. 6), an individual who used the alternative tax of Section 1201(b) would be denied the very net operating loss carryover allowed to a corporation by the decision below.

However, a corporate taxpayer, such as respondent, which employed the Section 1201(a) alternative tax would be permitted to exclude its entire net long-

term capital gains before determining the amount of its loss carryover. As the Fourth Circuit noted in *Mutual Assurance Society of Virginia Corp.* v. *Commissioner,* supra, 505 F. 2d at 135, there is nothing to indicate that Congress intended the phrase "taxable income" to have one meaning for corporations and another meaning for individuals. Nor is there anything to suggest that Congress intended to favor corporations over individuals for purposes of the net operating loss deduction. A uniform application of the Section 63(a) definition of "taxable income" would avoid the discriminatory treatment produced by the decision below.

C. RESPONDENT DID NOT HAVE A LOSS CARRYOVER FROM 1966 TO 1967 BECAUSE IT WOULD HAVE HAD NO "NET OPERATING LOSS" FOR 1966 WITHIN THE MEANING OF SECTION 172(C) HAD THE LOSS BEEN SUSTAINED IN THAT EARLIER YEAR

The error of the decision below can also be illustrated by the fact that it permitted respondent to carry over a loss from 1966 to 1967 even though it could not have carried over that loss had it been sustained in 1966. This proposition can be demonstrated as follows: Section 172(b)(1) provides that a "net operating loss" for a particular year shall be a "net operating loss carryback" to prior years or a "net operating loss carryover" to succeeding years. Without a "net operating loss," there can be no carryback or carryover. Section 172(c), Appendix, *infra,* p. 38, defines a "net operating loss" as "the excess of the deductions allowed by this chapter [Sections 1–1388] over the gross income." Thus, a taxpayer does not

have a "net operating loss" for a particular year unless its deductions exceed its gross income as defined by Section 61, which would include its ordinary income *and* its capital gains.

How does the statutory definition of "net operating loss" affect respondent's claim to a loss carryover to 1967? For 1966, respondent's gross income was $173,870.86 and its only available deduction derived from its 1968 net operating loss carryback of $42,203.12. Had that loss occurred in 1966, respondent would have had no "excess" of deductions over gross income for 1966 within the meaning of Section 172(c) which would have qualified as a net operating loss carryover to 1967.

Under that provision, the equation—gross income less deductions—must yield a negative figure before a "net operating loss" arises for use as a carryover or carryback to offset income for other taxable years. Similarly, here, where the 1968 loss was carried back to 1966 and thereby taken into account in computing the tax liability for that prior year, the result should be the same as the case where the loss occurred in 1966. In both instances, respondent had no "excess" of deductions over gross income for that year. Thus, Section 172(c) effectively refutes respondent's claim to a net operating loss carryover to 1967 equal to the difference between its 1966 ordinary income ($7,236.05) and its 1968 net operating loss ($42,203.12).

This statutory analysis is confirmed by the congressional understanding that absent a pre-existing carryback or carryover, no net operating loss deduc-

tion can be carried from a year in which the taxpayer does not suffer a loss. See Detailed Discussion of Certain Technical Provisions of the Revenue Bill of 1939 (H.R. Rep. No. 855, 76th Cong., 1st Sess. 17 (1939)). The figures for 1966 demonstrate that even after respondent took its 1968 loss carryback into account, it did not suffer a loss for 1966 but in fact had net income of $131,667.74. Thus, there is no remaining loss available for carryover to offset income for 1967.

The applicability of the Section 1201(a) tax computation for 1966 cannot create a net operating loss where there is a net gain for that year. As this Court stated in *Reo Motors* v. *Commissioner,* 338 U.S. 442, 449, with respect to the net operating loss carryover, in terms equally applicable to this case, "We find no warrant for the view that Congress intended that a statute designed to equalize tax burdens should be used to produce net losses where none had previously existed."

Moreover, the decision below permits a loss to offset income in another taxable year when that loss could not be used to offset the income of the year in which the loss was sustained, if the alternative tax computation were applicable. This can be illustrated by the following example. Suppose respondent incurred its $42,203.12 operating loss in 1966 instead of 1968. Under the alternative tax computation, which would still be applicable for that year, respondent could not offset its ordinary loss against its capital gains which were subject to the flat 25 percent tax. That rule was established more than 20 years ago in

Weil v. *Commissioner,* 23 T.C. 424, affirmed, 229 F. 2d 593 (C.A. 6), with respect to an individual taxpayer. Indeed, the validity of the *Weil* rule is not challenged here, for it was applied by the Tax Court to a corporation in the first issue considered in *Chartier Real Estate Co.* v. *Commissioner,* 52 T.C. 346, 350–356, affirmed *per curiam,* 428 F. 2d 474 (C.A. 1).

If respondent could not have used the $42,203.12 loss in 1966 to offset its $166,634.81 of capital gains and thereby reduce its effective tax rate below the 25 percent preferential capital gains rate of the alternative tax, it would be anomalous to allow it to carry such a loss forward to 1967, for use in offsetting income subject to a higher effective tax rate.[19] In short, the court below has allowed the very pyramiding of the benefits of the net operating loss carryback

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[19] As the Fourth Circuit pointed out in *Mutual Assurance* (505 F. 2d at 136–138), the Revenue Acts from 1924 to 1934 permitted the excess of deductions over ordinary income to reduce the amount of capital gains subject to the alternative capital gains rate. These early Acts permitted net operating losses carried back or carried over to offset long-term capital gains both under the regular and under the alternative computations. As demonstrated both by the *Weil* decision and by the decision of the primary issue in *Chartier* under the 1939 and 1954 Codes, this deduction was eliminated. When the net operating loss was restored in 1939, the statute provided that the net operating loss could offset capital gains when taxed at regular rates, but not when taxed at the favorable alternative rates. Thus, the Fourth Circuit concluded with respect to the secondary holding in *Chartier* at issue here (505 F. 2d at 138): "The Tax Court's remedy is a ruling that such excess will be available in the future to offset ordinary income. Thus, the Tax Court has extended a greater benefit to the taxpayer than Congress did when it expressly addressed itself to this problem on a prior occasion, and we think incorrectly so."

deductions and the alternative tax computation that *Weil* foreclosed with respect to an ordinary loss and capital gains occurring in a single taxable year.[20]

Finally, the decision below unfairly elevates the status of the net operating loss carryback deduction over every other type of deduction against gross income permitted by the Code. For example, suppose that respondent had sustained a $1,000 ordinary loss for 1966 instead of the $7,236.05 of ordinary income it actually received. The large amount of capital gains for that year ($166,634.81) would continue to make the alternative tax computation applicable both before and after the carryback of the 1968 loss of $42,203.12. Under the *Weil* case, the $1,000 ordinary loss does not reduce the capital gains subject to the alternative tax and it cannot be carried forward to 1967 because there is no "excess" of deductions over gross income within the meaning of Section 172(c).

However, *Chartier* and the decision below would permit the $42,203.12 loss to be carried back to 1966 and, because it did not "affect" the alternative tax computation for that year, that loss could be carried forward to 1967. There is, in fact, no difference between the $1,000 loss sustained in 1966 and the $42,203.12 loss sustained in 1968. Both losses are

[20] The courts have generally foreclosed taxpayers' attempts to cumulate the benefits of the loss carryback and carryover provision with those of the capital gains provisions of the Code. See, *e.g.*, *Little* v. *Commissioner*, 294 F. 2d 661 (C.A. 9) and *Kaecker* v. *Commissioner*, 30 T.C. 897. See also *Payne* v. *United States*, 489 F. 2d 1404 (Ct. Cl.) (income averaging); *Estate of Gadlow* v. *Commissioner*, 50 T.C. 975 (averaging of breach of contract damages); and *Redpath* v. *Commissioner*, 19 T.C. 470 (averaging of back pay award).

ordinary deductions which are entitled to equal status in the Code[21] and both losses do not "affect" the alternative tax computation for 1966.

Thus, if the $1,000 loss cannot be carried forward to 1967, the $42,203.12 loss should likewise be ineligible for carryover to a succeeding year. In the absence of an explicit congressional direction to the contrary, there is no sound policy reason to construe the Code to require such unequal treatment of equivalent types of deductions against gross income.[22]

[21] See Section 161 which appears to suggest that all deductions are of equal rank or significance. It provides that "[i]n computing taxable income under section 63(a), there shall be allowed as deductions the items specified in this part [Sections 161–187] * * *." Cf. *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1, 17.

[22] The *Chartier* attempt to merge the net operating loss provisions with the alternative computation under Section 1201 produces strikingly disparate results arising from small differences in figures, as illustrated by the recent decision in *Lone Manor Farms, Inc.* v. *Commissioner*, 61 T.C. 436. If long-term capital gains are large, other income is small, and deductions are large, the regular tax computation under Section 11 may, and often will, produce the smaller tax, thereby making *Chartier* inapplicable.

In *Lone Manor Farms*, the taxpayer had net operating losses of $8,207.60 and $30,124.62 for 1965 and 1966, respectively. In 1967, it had taxable income of $259,621.12 prior to the application of the net operating losses of the preceding years. This included a net long-term capital gain of $313,531.39 and deductions in excess of ordinary income of $53,910.27. Applying the net operating losses of the preceding years, this produced a tax of $99,718.67 for 1967 when computed under the regular Section 11 method, but an alternative tax of $78,382.85 when computed under the alternative Section 1201 method. Consequently, the tax of $78,382.85 was paid. Pursuant to *Chartier*, the net operating loss carryovers from 1965 and 1966, aggregating $38,332.22, were available for further carryover since they were not "used" in the alternative computation.

CONCLUSION

For the reasons stated, the judgment of the court of appeals should be reversed and remanded to the district court with directions to dismiss the complaint.

Respectfully submitted.

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However, in 1968, the taxpayer had a further net operating loss of $30,529.78, in 1969 taxable income of $135,130.89 and in 1970 a net operating loss of $23,490.08. The taxpayer sought to apply its 1965 and 1966 net operating losses aggregating $38,332.22 (available under *Chartier*) and its 1968 and 1970 net operating losses aggregating $54,019.86 to offset its 1969 income. But when the 1968 and 1970 net operating losses were first carried back to 1967, as Section 172(b)(2) requires, and the 1967 tax recomputed, the regular computation under Section 11 produced a tax of $73,789.14, as compared with the alternative computation, so that the regular method was applicable.

Thus, under *Chartier*, the difference of $4,593.71 between the regular and the alternative methods of computing taxpayer's tax for 1967 governed the availability for other years of net operating losses aggregating $92,352.08. It seems hardly likely that such a small difference between the regular and the alternative tax should warrant such disparate results.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 11 [as amended by Sec. 121, Revenue Act of 1964, P.L. 88-272, 78 Stat. 19, 25]. Tax Imposed.

(a) *Corporations in General.*—A tax is hereby imposed for each taxable year on the taxable income of every corporation. The tax shall consist of a normal tax computed under subsection (b) and a surtax computed under subsection (c).

(b) *Normal Tax.*—The normal tax is equal to the following percentage of the taxable income:

(1) 30 percent, in the case of a taxable year beginning before January 1, 1964, and

(2) 22 percent, in the case of a taxable year beginning after December 31, 1963.

(c) *Surtax.*—The surtax is equal to the following percentage of the amount by which the taxable income exceeds the surtax exemption for the taxable year:

(1) 22 percent, in the case of a taxable year beginning before January 1, 1964,

(2) 28 percent, in the case of a taxable year beginning after December 31, 1963, and before January 1, 1965, and

(3) 26 percent, in the case of a taxable year beginning after December 31, 1964.

(d) *Surtax Exemption.*—For purposes of this subtitle, the surtax exemption for any taxable year is $25,000, except that, with respect to a corporation to which section 1561 (relating to surtax exemptions in case of certain controlled corporations) applies for the taxable year, the

surtax exemption for the taxable year is the amount determined under such section.

* * * * *

Sec. 63. Taxable income defined.

(a) *General Rule.*—Except as provided in subsection (b), for purposes of this subtitle the term "taxable income" means gross income, minus the deductions allowed by this chapter, other than the standard deduction allowed by part IV (sec. 141 and following).

* * * * *

Sec. 172. Net operating loss deduction.

(a) *Deduction Allowed.*—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

(b) [as amended by Sec. 317(b), Trade Expansion Act of 1962, P.L. 87-794, 76 Stat. 872, 889, and Secs. 210(a) and 210(b), Revenue Act of 1964, *supra,* 78 Stat. 47-49] *Net Operating Loss Carrybacks and Carryovers.*—

(1) *Years to which loss may be carried.*—

(A)(i) Except as provided in clause (ii) and in subparagraph (D), a net operating loss for any taxable year ending after December 31, 1957, shall be a net operating loss carryback to each of the 3 taxable years preceding the taxable year of such loss.

(ii) In the case of a taxpayer with respect to a taxable year ending on or after December 31, 1962, for which a certification has been issued under section 317 of the Trade Expansion Act of 1962, a net operating loss for such taxable year shall be a net operating loss carryback to each of the 5 taxable years preceding the taxable year of such loss.

(B) Except as provided in subparagraphs (C) and (D), a net operating loss for any taxable year ending after December 31, 1955, shall be a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss.

* * * * *

(2) *Amount of carrybacks and carryovers.*—Except as provided in subsections (i) and (j), the entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the "loss year") shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. For purposes of the preceding sentence, the taxable income for any such prior taxable year shall be computed—

(A) with the modifications specified in subsection (d) other than paragraphs (1), (4) and (6) thereof; and

(B) by determining the amount of the net operating loss deduction—

(i) without regard to the net operating loss for the loss year or for any taxable year thereafter, and

(ii) without regard to that portion, if any, of a net operating loss for a taxable year attributable to a foreign expropriation loss, if such portion may not, under paragraph (1)(D), be carried back to such prior taxable year,

and the taxable income so computed shall not be considered to be less than zero. For purposes of this paragraph, if a portion of the net operating loss for the loss year is attributable to a foreign expropriation loss to which paragraph (1)(D) applies, such portion shall be consid-

ered to be a separate net operating loss for such year to be applied after the other portion of such net operating loss.

* * * * *

(c) *Net Operating Loss Defined.*—For purposes of this section, the term "net operating loss" means (for any taxable year ending after December 31, 1953) the excess of the deductions allowed by this chapter over the gross income. Such excess shall be computed with the modifications specified in subsection (d).

(d) *Modifications.*—The modifications referred to in this section are as follows:

(1) *Net operating loss deduction.*—No net operating loss deduction shall be allowed.

(2) *Capital gains and losses of taxpayers other than corporations.*—In the case of a taxpayer other than a corporation—

* * * * *

(B) the deduction for long-term capital gains provided by section 1202 shall not be allowed.

* * * * *

Sec. 1201. Alternative tax.

(a) [as amended by Sec. 8(g)(3), Revenue Act of 1962, P.L. 87–834, 76 Stat. 960, 999] *Corporations.*—If for any taxable year the net long-term capital gain of any corporation exceeds the net short-term capital loss, then, in lieu of the tax imposed by sections 11, 511, 821 (a) or (c), and 831(a), there is hereby imposed a tax (if such tax is less than the tax imposed by such sections) which shall consist of the sum of—

(1) a partial tax computed on the taxable income reduced by the amount of such excess, at the rates and in the manner as if this subsection had not been enacted, and

(2) an amount equal to 25 percent of such excess, or, in the case of a taxable year beginning before April 1, 1954, an amount equal to 26 percent of such excess.

In the case of a taxable year beginning before April 1, 1954, the amount under paragraph (2) shall be determined without regard to section 21 (relating to effect of change of tax rates).

(b) *Other taxpayers.* If for any taxable year the net long-term capital gain of any taxpayer (other than a corporation) exceeds the net short-term capital loss, then, in lieu of the tax imposed by sections 1 and 511, there is hereby imposed a tax (if such tax is less than the tax imposed by such sections) which shall consist of the sum of—

(1) a partial tax computed on the taxable income reduced by an amount equal to 50 percent of such excess, at the rate and in the manner as if this subsection had not been enacted, and

(2) an amount equal to 25 percent of the excess of the net long-term capital gain over the net short-term capital loss.

Sec. 1202. Deduction for capital gains.

In the case of a taxpayer other than a corporation, if for any taxable year the net long-term capital gain exceeds the net short-term capital loss, 50 percent of the amount of such excess shall be a deduction from gross income. In the case of an estate or trust, the deduction shall be computed by excluding the portion (if any), of the gains for the taxable year from sales or exchanges of capital assets, which, under sections 652 and 662 (relating to inclusions of amounts in gross income of beneficiaries of trusts), is includible by the income beneficiaries as gain derived from the sale or exchange of capital assets.

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.172–4 Net operating loss carrybacks and net operating loss carryovers.

* * * * *

(b) *Portion of net operating loss which is a carryback or a carryover to the taxable year in issue*—(1) *Manner of computation.* (i) * * *

(ii) The portion of the loss which shall be carried to any of such several taxable years subsequent to the earliest taxable year is the excess of such net operating loss over the sum of the aggregate of the taxable incomes (computed as provided in § 1.172–5) for all of such several taxable years preceding such subsequent taxable year which are subject to the Internal Revenue Code of 1954 and the aggregate of the net incomes (computed as provided in 26 C.F.R. (1939) 39.122–4(c) (Regulations 118) or in the corresponding section of prior applicable regulations) for all of such preceding taxable years which are subject to the Internal Revenue Code of 1939.

* * * * *

§ 1.172–5 Taxable income which is subtracted from net operating loss to determine carryback or carryover.

(a) *Taxable year subject to the Internal Revenue Code of 1954.* The taxable income for any taxable year subject to the Internal Revenue Code of 1954 which is subtracted from the net operating loss for any other taxable year to determine the portion of such net operating loss which is a carryback or a carryover to a particular taxable year is computed with the modifications prescribed in this paragraph. These modifications shall be made independently of, and without reference to, the modifications required by §§ 1.172–2(a) and 1.172–3(a)

for purposes of computing the net operating loss itself.

(1) *Modifications applicable to corporations only.* In the case of a corporation the deductions provided by section 242 (relating to partially tax-exempt interest) and by section 922 (relating to Western Hemisphere trade corporations) shall not be allowed.

* * * * *

(3) *Modifications applicable to all taxpayers.* In the case either of a corporation or of a taxpayer other than a corporation—

(i) *Net operating loss deduction.* The net operating loss deduction for such taxable year shall be computed by taking into account only such net operating losses otherwise allowable as carrybacks or carryovers to such taxable year as were sustained in taxable years preceding the taxable year in which the taxpayer sustained the net operating loss from which the taxable income is to be deducted. Thus, for such purposes, the net operating loss for the loss year or any taxable year thereafter shall not be taken into account.

Example. The taxpayer's income tax returns are made on the basis of the calendar year. In computing the net operating loss deduction for 1954, the taxpayer has a carryover from 1952 of $9,000, a carryover from 1953 of $6,000, a carryback from 1955 of $18,000, and a carryback from 1956 of $10,000, or an aggregate of $43,000 in carryovers and carrybacks. Thus, the net operating loss deduction for 1954, for purposes of determining the tax liability for 1954, is $43,000. However, in computing the taxable income for 1954 which is subtracted from the net operating loss for 1955 for the purpose of determining the portion of such loss which may be carried over to subsequent taxable years, the net operating loss deduction for 1954 is $15,000, that is, the aggregate of the $9,000 carryover from 1952 and the $6,000 carryover from 1953.

In computing the net operating loss deduction for such purpose, the $18,000 carryback from 1955 and the $10,000 carryback from 1956 are disregarded. In computing the taxable income for 1954, however, which is subtracted from the net operating loss for 1956 for the purpose of determining the portion of such loss which may be carried over to subsequent taxable years, the net operating loss deduction for 1954 is $33,000, that is, the aggregate of the $9,000 carryover from 1952, the $6,000 carryover from 1953, and the $18,000 carryback from 1955. In computing the net operating loss deduction for such purpose, the $10,000 carryback from 1956 is disregarded.

(ii) *Recomputation of percentage limitations.* Unless otherwise specifically provided in this subchapter, any deduction which is limited in amount to a percentage of the taxpayer's taxable income or adjusted gross income shall be recomputed upon the basis of the taxable income or adjusted gross income, as the case may be, determined with the modifications prescribed in this paragraph. Thus, in the case of an individual the deduction for medical expenses would be recomputed after making all the modifications prescribed in this paragraph, whereas the deduction for charitable contributions would be determined without regard to any net operating loss carryback but with regard to any other modifications so prescribed. See, however, the regulations under paragraph (g) of § 1.170–2 (relating to charitable contributions carryover of individuals) and paragraph (e) of § 1.170–3 (relating to charitable contributions carryover of corporations) for special rules regarding charitable contributions in excess of the percentage limitations which may be treated as paid in succeeding taxable years.

Example (1). For the calendar year 1954 the taxpayer, an individual, files a return showing taxable income of $4,800, computed as follows:

Salary		$5,000
Net long-term capital gain		4,000
Total gross income		9,000
Less: Deduction allowed by section 1202 in respect of net long-term capital gain		2,000
Adjusted gross income		7,000
Less:		
Deduction for personal exemption	$600	
Deduction for medical expense ($410 actually paid but allowable only to extent in excess of 3 percent of adjusted gross income)	200	
Deduction for charitable contributions ($2,000 actually paid but allowable only to extent not in excess of 20 percent of adjusted gross income)	1,400	
		2,200
Taxable income		4,800

In 1955 the taxpayer undertakes the operation of a trade or business and sustains therein a net operating loss of $3,000. Under section 172 (b)(2), it is determined that the entire $3,000 is a carryback to 1954. In 1956 he sustains a net operating loss of $10,000 in the operation of the business. In determining the amount of the carryover of the 1956 loss to 1957, the taxable income for 1954 as computed under this paragraph is $3,970, determined as follows:

Salary		$5,000
Net long-term capital gain		4,000
Total gross income		9,000
Less: Deduction for carryback of 1955 net operating loss		3,000
Adjusted gross income		6,000
Less:		
Deduction for medical expense ($410 actually paid but allowable only to extent in excess of 3 percent of adjusted gross income as modified under this paragraph)	$230	
Deduction for charitable contributions ($2,000 actually paid but allowable only to extent not in excess of 20 percent of adjusted gross income determined with all the modifications prescribed in this paragraph other than the net operating loss carryback)	1,800	
		2,030
Taxable income		3,970

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Example (2). For the calendar year 1959 the taxpayer, an individual, files a return showing taxable income of $5,700, computed as follows:

Salary		$5,000
Net long-term capital gain		4,000
Total gross income		9,000
Less: Deduction allowed by section 1202 in respect of net long-term capital gain		2,000
Adjusted gross income		7,000
Less:		
Deduction for personal exemption	$600	
Standard deduction allowed by section 141	700	
		1,300
Taxable income		5,700

In 1960 the taxpayer undertakes the operation of a trade or business and sustains therein a net operating loss of $4,700. In 1961 he sustains a net operating loss of $10,000 in the operation of the business. Under section 172(b)(2), it is determined that the entire amount of each loss, $4,700 and $10,000, is a carryback to 1959. In determining the amount of the carryover of the 1961 loss to 1962, the taxable income for 1959 as computed under this paragraph is $3,870, determined as follows:

Salary	$5,000
Net long-term capital gain	4,000
Total gross income	9,000
Less: Deduction for carryback of 1960 net operating loss	4,700
Adjusted gross income	4,300
Less: Standard deduction	430
Taxable income	3,870

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OCTOBER TERM, 1975

No. 74-799

UNITED STATES OF AMERICA,
Petitioner,

vs.

FOSTER LUMBER COMPANY, INC.,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF OF THE RESPONDENT

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INDEX

Question presented 1

Statement of the case 2

Summary of argument 4

Argument:

Preliminary statement on the decisions below and on the structure of the argument 7

I. The decision below effectuates the purposes of both of the relevant statutes 12

A. The purpose of Section 172, to mitigate the effects of arbitrary annual accounting periods, compels the result below 13

B. The purpose of Section 1201, to tax capital gains at lower rates, would be offended by a rule making the realization of a capital gain cause the loss of the benefit of an operating loss carryover 20

C. The interpretation sponsored by the Government would destroy equality of treatment between taxpayers similarly situated whenever a capital gain occurs in a year to which an NOL may be carried 22

Table C: Effect of one-time capital gain on tax benefit derived from net operating loss 25

II. The statutory language is consistent with the result below 26
A. The decision below did not construe the words "taxable income" standing alone 27
B. The statutory language is consistent with the construction below 28
III. The supposed anomalies of the *Chartier* rule, advanced by the Government, involve no inconsistency and do not support the Government position 32
A. The computation of the net operating loss generated in a loss year is required by express provisions to be different from the computation of "absorption" in a carry year 33
B. The decision below creates no disparity between corporate and noncorporate taxpayers 34
C. *Weil*, as extended in the ruling on the first petition in *Chartier* is entirely consistent with *Chartier's* ruling on the second petition and with the decision below 36
D. The Government and *Mutual Assurance* misconstrue the legislative history which contributed to *Weil* 39
Conclusion 42
Appendix A 43
Appendix B 48

CITATIONS

Cases:

Sidney Axelrod, 32 CCH Tax Ct. Mem. 885 (1973), rev'd, 507 F.2d 884 (6th Cir. 1974) 8, 35
Axelrod v. *Commissioner*, 507 F.2d 884 (6th Cir. 1974) 8, 35, 42
Chartier Real Estate Co., 52 T.C. 346 (1969), aff'd per curiam, 428 F.2d 474 (1st Cir. 1970) 8, 12, 15-18, 27-28, 30-32, 35-38
Chartier Real Estate Co. v. *Commissioner*, 428 F.2d 474 (1st Cir. 1970) 8, 18
Corn Products Ref. Co. v. *United States*, 350 U.S. 46 (1956) 23
Data Products Corp. v. *United States*, No. ..... (9th Cir., Dec. 27, 1974), petition for cert. filed, 43 U.S.L.W. 3454 (U.S. Feb. 10, 1975) (No. 74-996) 8
Foster Lumber Co. v. *United States*, 500 F.2d 1230 (8th Cir. 1974) 8-9, 11, 12, 15, 28, 35
Gregory v. *Helvering*, 263 U.S. 465 (1935) 22-23
Harrison v. *Schaffner*, 312 U.S. 579 (1941) 23
Libson Shops v. *Koehler*, 353 U.S. 382 (1957) 19-20
Lone Manor Farms, Inc., 61 T.C. 436 (1974) 39
Mutual Assurance Soc'y, 32 CCH Tax Ct. Mem. 839 (1973), rev'd, 505 F.2d 128 (4th Cir. 1974) 8
Mutual Assurance Soc'y v. *Commissioner*, 505 F.2d 128 (4th Cir. 1974) 8, 9, 35, 39-41
Naegele v. *United States*, 32 Am. Fed. Tax R.2d 73-5689 (D.Minn. 1973), appeal docketed, No. 73-1921, 8th Cir., Dec. 26, 1973 8
Olympic Foundry Co. v. *United States*, 29 Am. Fed. Tax R.2d 72-759 (D.Wash. 1972), aff'd per curiam, 493 F.2d 1247 (9th Cir. 1974) 8

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Act of Feb. 24, 1919, ch. 18, §204(b), 40 Stat. 1061 .. 17, 43
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Act of June 6, 1932, ch. 209, §101(a), (c)(5), 47 Stat. 169 40
Act of June 16, 1933, ch. 90, §218(a), 48 Stat. 209 .. 42-43
Act of May 28, 1938, ch. 289, §26(c), 52 Stat. 467 44
Act of June 29, 1939, ch. 247, §122(b), 53 Stat. 867 .. 44
Act of Oct. 21, 1942, ch. 619, §153(a), 56 Stat. 847 .. 21, 45
Act of Sept. 23, 1950, ch. 994, §215(a), 64 Stat. 937 .. 45
Act of Aug. 16, 1954, ch. 736, §172, 68A Stat. 63 46
Act of Sept. 2, 1958, Pub. L. No. 85-866, §203(a), 72 Stat. 1678 46
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Int. Rev. Code of 1954:

§11 ..... 13, 15, 20, 22, 29-32
§63(a) 31
§172 ..... 2, 4-9, 11-14, 17-20, 23, 25-36, 38
§1202 ..... 21, 34, 35

Miscellaneous:

57 CONG. REC. 513 (1918) 43
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S. REP. No. 665, 72d Cong., 1st Sess. 11 (1932) 43
S. REP. No. 1881, 87th Cong., 2d Sess. 129 (1962) 19

In the Supreme Court of the United States

OCTOBER TERM, 1975

No. 74-799

UNITED STATES OF AMERICA,
Petitioner,

vs.

FOSTER LUMBER COMPANY, INC.,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF OF THE RESPONDENT

QUESTION PRESENTED

For income tax purposes a corporation is entitled to carry a net operating loss three years back and five years forward until the loss is absorbed. Whenever a year to which the loss is carried does not have sufficient ordinary income to absorb all of the loss, but has a capital gain required to be taxed at the 25% "alternative tax" rate provided for in Section 1201(a) of the Internal Revenue Code, the remaining loss not absorbed by ordinary income does not diminish the capital gain subject to the 25% tax.

In such a case, does the taxed capital gain absorb loss, or is the amount of the loss in excess of the ordinary income of the year available for use in a later year?

STATEMENT OF THE CASE

This is a tax refund case. Respondent[1] claimed a Federal income tax refund for its fiscal year ended March 31, 1967, based upon a net operating loss deduction[2] resulting from a carryback of a later year's net operating loss.[3] The Internal Revenue Service denied the claim for refund on the ground that the net operating loss in question had been fully "absorbed" in fiscal 1966 leaving no net operating loss deduction in fiscal 1967 under its interpretation of the applicable statute. The question in this case therefore concerns "absorption" in fiscal 1966. Under Section 172(e) (all section references herein are to the Internal Revenue Code of 1954 unless otherwise indicated) the question is to be decided under the law applicable to that taxable year.

Table A following extracts from the Appendix (A. 14) the applicable income, loss, and capital gain figures, stated by years.

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1. Respondent in fact is the successor to Foster Lumber Company, the taxpayer involved. (A. 14) The term "Respondent" as used herein includes the predecessor corporation.

2. The "net operating loss deduction" is the sum of the net operating loss carryovers and carrybacks to the year. INT. REV. CODE OF 1954, §172(a).

3. A "net operating loss" in general is a net operating loss carryback to each of the three taxable years preceding the loss year and a net operating loss carryover to each of the five taxable years following the loss year. Sections 172(b)(1)(A) and (B). The net operating loss must be carried initially to the third preceding taxable year; then to the extent not used to offset income, it is carried to later years in chronological order. INT. REV. CODE OF 1954, §172(b)(2).

TABLE A

Applicable Income, Loss and Capital Gain Figures Stated by Years

Taxable Year Ended	Ordinary Income	Capital Gain	Total
3/31/66	$ 7,236	$166,635	$173,871
3/31/67	114,262	114,656	228,918
3/31/68	—(Irrelevant—Not Stipulated)—		
7/19/68	(42,203)	–0–	(42,203)
3-Year Totals	$ 79,295	$281,291	$360,586

As Table A shows, the net operating loss occurred in Respondent's short taxable year ended July 19, 1968.[4] The amount of that loss, $42,203, was carried back first to fiscal 1966, creating in that year a net operating loss deduction. In that year, Respondent had, prior to the application of the net operating loss deduction, net ordinary income of $7,236 and a capital gain of $166,635.[5] The parties agree that a portion of the net operating loss deduction was applied against and erased the $7,236 of ordinary income. However, neither the capital gain of $166,635, nor the 25% tax assessed against it under the alternative tax computa-

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4. It perhaps should be mentioned that Respondent also had a 12-month taxable year ended March 31, 1968; otherwise, the reader may question whether fiscal 1966 was the third taxable year preceding the loss year.

5. Throughout this brief, the excess of net long-term capital gain over net short-term capital loss is referred to as "capital gain." All other taxable income resulting when net operating loss deductions are not taken into account is referred to as "ordinary income" or "ordinary operating income."

tion of Section 1201(a),[6] was affected by the remainder (approximately $35,000) of the available net operating loss deduction.

The question presented is whether the $35,000 was absorbed by the existence of the capital gain in fiscal 1966, or whether it remains available to reduce the ordinary income of fiscal 1967.

SUMMARY OF ARGUMENT

The purpose of Section 172, as shown clearly by its legislative history and the decisions construing it, is to ameliorate the tax consequences of fiscal year taxation for taxpayers with earnings which fluctuate sharply from profit to loss. Section 172 is structured to accomplish this purpose by allowing a deficit in income for one tax year to be deemed a "net operating loss deduction", which may be deducted from earnings in the preceding three and subsequent five taxable years (as if the earnings and deficits had been more evenly distributed).

The alternative tax provisions in Section 1201 have an equally clear purpose: to place an effective ceiling on the tax assessable against long-term capital gain by segregating it from ordinary income for taxation at a special rate (25% at the time in question), whenever such separate taxation produces a lower aggregate tax for the year.

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6. Act of Oct. 16, 1962, Pub. L. No. 87-834, §8(g)(3), 76 Stat. 999, *amending*, Int. Rev. Code of 1954, ch. 736, §1201(a), 68A Stat. 320, *as amended*, INT. REV. CODE OF 1954, §1201(a). All references to Section 1201 will be to this version, which was effective for Respondent's 1966 taxable year.

It is undisputed that when one of the eight years over which deficits in earnings may be distributed as a "net operating loss deduction" under Section 172 is also a year in which the taxpayer has a capital gain and the alternative tax is lower, the net operating loss deduction may be used to reduce only the income which is taxed at regular tax rates under the "partial tax" provisions of Section 1201. The net operating loss deduction has no effect on the segregated capital gain component of income or on the separate tax assessed against it.

Because a portion of the net operating loss deduction is carried onward from year to year until it is exhausted (or until the carryover period elapses), it is necessary to determine whether the portion of the net operating loss deduction which may be carried to years subsequent to an alternative tax year is (a) the portion which exceeds the ordinary income from which it may be and has been deducted; or (b) the portion which exceeds the *sum* of that income *plus* the unaffected, segregated capital gain, from which it is *not* deductible and has not been deducted.

The first of these constructions serves the purpose of Section 172 by preserving equal treatment between taxpayers similarly situated during the carryover period except for the timing of capital gains; and also serves the purpose of Section 1201 by preserving the ceiling on the tax rate for capital gain.

The latter, Government construction creates unequal tax results between taxpayers distinguished only by whether and when they experience capital gain, and thus contravenes both (a) the equalizing function of Section 172, by making the fiscal year in which the capital gain occurs govern tax consequences; and (b) the function of

Section 1201, by making the occurrence of a capital gain cause the loss of the tax benefit in subsequent years of a pre-existing net operating loss deduction, thereby effectively nullifying the ceiling on capital gain taxes.

The Tax Court, the court below, and two other circuits have construed the language of the second sentence of subsection 172(b)(2) to be compatible with the construction required to effect the legislative purpose. Those courts. and Respondent, read the sentence as providing that the amount of the potential deduction remaining after its application in one year is the excess of the net operating loss over that part of the year's income from which it may be deducted, i.e., in an alternative tax year, over the income on which the partial tax is assessed. In light of such authority, the Government's principal contention, that the language of the sentence permits no such construction, is without force.

The Government's observations regarding the difference which exists, under Respondent's construction of Section 172, between the computations determining (a) the net operating loss to be carried to other taxable years, and (b) the portion of a loss so determined which remains to be deducted in taxable years subsequent to an alternative tax year, are not instructive, because such differences are inherent in the statutory scheme. The Government's assertion that the decision below creates a disparity of treatment between individual and corporate taxpayers simply derives from a misunderstanding of the computations prescribed by the statutes. Its contention that Congress intended a lesser tax benefit than that granted by the decision below arises from an invalid inference from a fragment of legislative history viewed out of context.

Respondent was thus entitled to the refund claimed and awarded below.

ARGUMENT

Preliminary Statement on the Decisions Below and on the Structure of the Argument.

The technical tax question presented arises at the intersection of two widely separated divisions of the Internal Revenue Code, each having distinct objectives: (i) Section 172, providing for loss spreading so that a taxpayer with fluctuating operating results is allowed to treat operating losses concentrated in one tax year as if they had been distributed over one or more (up to eight) additional years; and (ii) Section 1201, providing special tax treatment of capital gains.

Respondent encountered the intersection when it carried its 1968 net operating loss of $42,000[7] back to 1966, applied it there to absorb $7,000 of 1966 ordinary income, and then sought to apply the remaining $35,000 to ordinary income of the next year, 1967. Its application in 1967, and the consequent tax refund claimed, has been sustained by the courts thus far over the objection of the United States, which vigorously asserts that all of Respondent's $42,000 loss was "absorbed" in 1966, including the $35,000 of the 1968 loss which could not be applied in any meaningful manner in 1966. There was a $167,000 capital gain in 1966. According to the Government, its presence in that year caused the absorption of all the net operating loss. Yet, the parties agree that the actual capital gain of $167,000 and the 25% tax imposed thereon by the alternative tax provision of Section 1201(a) was not reduced by the presence

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7. See Table B which rounds figures to thousands of dollars. The rounded figures are normally used hereinafter.

of the $35,000 balance of the loss carried back,[8] since it is the long established rule that no deficit in ordinary income may be used to reduce capital gain when the alternative tax applies.[9]

The issue of absorption posed by this case may arise in any of the eight years to which Section 172 permits the carrying of losses, except the last.

The court below[10] ruled in accordance with an unwavering line of authority from the Tax Court,[11] the circuits,[12] and district courts,[13] that a corporate taxpayer is

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8. *See, e.g.*, Petitioner's Brief at 30-31, 32 [hereinafter cited as G.Br.].

9. *Chartier Real Estate Co.*, 52 T.C. 346 (1969), *aff'd per curiam*, 428 F.2d 474 (1st Cir. 1970) ("carry" years); *Walter M. Weil*, 23 T.C. 424 (1954), *aff'd*, 229 F.2d 593 (6th Cir. 1956) (loss year).

10. *Foster Lumber Co.* v. *United States*, 500 F.2d 1230 (8th Cir. 1974).

11. *Chartier Real Estate Co.*, 52 T.C. 346 (1969), *aff'd per curiam*, 428 F.2d 474 (1st Cir. 1970), was the Tax Court's first decision of the issue and has been followed consistently by the Tax Court in all later cases. *See Sidney Axelrod*, 32 CCH Tax Ct. Mem. 885 (1973), *rev'd*, 507 F.2d 884 (6th Cir. 1974); *Mutual Assurance Soc'y*, 32 CCH Tax Ct. Mem. 839 (1973), *rev'd*, 505 F.2d 128 (4th Cir. 1974).

12. *Olympic Foundry Co.* v. *United States*, 493 F.2d 1247 (9th Cir. 1970) (per curiam); *Chartier Real Estate Co.* v. *Commissioner*, 428 F.2d 474 (1st Cir. 1970) (per curiam). After the *Foster Lumber* decision, this line of authority was followed in *Data Products Corp.* v. *United States*, No. ..... (9th Cir., Dec. 27, 1974), *petition for cert. filed*, 43 U.S.L.W. 3454 (U.S. Feb. 10, 1975) (No. 74-996). *Axelrod* v. *Commissioner*, 507 F.2d 884 (6th Cir. 1974), and *Mutual Assurance Soc'y* v. *Commissioner*, 505 F.2d 128 (4th Cir. 1974), were decided subsequent to the *Foster Lumber* decision.

13. *Naegele* v. *United States*, 32 Am. Fed. Tax R.2d 73-5689 (D.Minn. 1973), *appeal docketed*, No. 73-1921, 8th Cir., Dec. 26, 1973; *Olympic Foundry Co.* v. *United States*, 29 Am. Fed. Tax R.2d 72-759 (D.Wash. 1972), *aff'd per curiam*, 493 F.2d 1247 (9th Cir. 1974).

not deprived of all or part of the tax benefit of an operating loss carryback or carryover merely because it happened to experience a capital gain in a year to which a net operating loss from another year is carried. The Government here contends the contrary, relying primarily on a subsequent decision in which the Fourth Circuit reversed the Tax Court.[14]

The decision below, in favor of the taxpayer, was founded on the conclusion that it is impossible to find any plain meaning in the statutory language, but that "the basic policy considerations underlying Sections 1201 and 172 decisively support the result reached by the district court," in favor of the taxpayer. 500 F.2d at 1232. In support of this conclusion, the court observed that "to hold otherwise would frequently subject otherwise similarly situated taxpayers to significantly different treatment solely on the basis of arbitrary timing; precisely the reverse of Section 172's original purpose." 500 F.2d at 1232.

Although the Court of Appeals did not give a specific example of the arbitrary consequences of timing if the Government's contention were accepted, this phenomenon can be illustrated by simple adjustments to Table B, on the following page, which illustrates Respondent's pertinent income history in numbers rounded to the nearest $1,000.

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14. *Mutual Assurance Soc'y* v. *Commissioner*, 505 F.2d 128 (4th Cir. 1974).

TABLE B

Applicable Income, Loss and Capital Gain Figures of Respondent, Stated by Years and Rounded

Taxable Year Ended in	Ordinary Income (Net)	Capital Gain	Total
1966	$ 7,000	$167,000	$174,000
1967	114,000	115,000	229,000
1968*	(42,000)	–0–	(42,000)
3-Year Totals	$ 79,000	$282,000	$361,000

If the taxpayer's $167,000 capital gain had been realized in 1967 rather than in 1966, even the Government would concede that the taxpayer's 1968 NOL of $42,000 would be applied first to the 1966 ordinary income to the extent of $7,000 and then to the 1967 ordinary income to the extent of the remaining $35,000, with the result that the total amount of income taxed over the three-year period would be $361,000—the taxpayer's actual net economic gain for the three years. Similarly, if the 1967 ordinary income had been realized in 1966, the Government would concede that the full amount of the 1968 loss could be carried back and applied against the hypothesized 1966 ordinary income of $121,000. This, too, would result in taxing a total of $361,000 over the three-year period, corresponding to the taxpayer's aggregate economic gain. Solely because the taxpayer's long-term capital gain was actually realized in 1966, and its ordinary income was small, the Government contends that the taxpayer's 1968 NOL was "absorbed" by capital gain, although this

*Refers to the pertinent year ended July 19, 1968. See note 4 and Table A, *supra*.

metaphysical "absorption" of the NOL did not reduce the 1966 alternative tax, and although such "absorption" makes the income taxed in the three years $396,000—$35,000 more than the taxpayer's net economic gain.

It would be ironic indeed if a statutory provision designed, as the court below observed, "to ameliorate the harsh tax consequences that can result from the necessity of accounting for certain exceptional economic events within the confines of an arbitrary annual accounting period" (500 F.2d at 1232), should have this precisely contrary effect.

Respondent feels it necessary to use a different sequence of presentation than the Government did, in order (1) to relate the issues more closely to the decision here for review; and (2) to identify and properly distinguish among the points which the Government Brief undiscriminatingly mixes together. For example, the Government has elected to disregard the policy-oriented basis of the decision below and to organize its arguments to emphasize bare syntactical arguments directed at a "straw man". The first and lengthier of the Government's two enumerated arguments (G.Br., pp. 17-28) consists almost exclusively of a grammatical analysis of the phrase "the excess . . . of the amount of such [net operating] loss over the sum of the taxable income for each of the prior years to which such loss may be carried."[15] However, neither the decision

15. Quoted from Section 172(b)(2), which reads:

"Except as provided in subsections (i) and (j), the entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the 'loss year') shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. *The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried.*" (Emphasis added.)

here for review nor the acknowledged leading decision of the Tax Court, *Chartier Real Estate Co.*, 52 T.C. 346 (1969), aff'd per curiam, 428 F.2d 474 (1st Cir. 1970), is based, as the Government strains so greatly to imply (e.g., G.Br., pp. 8-9, 20), on a conclusion that the phrase "to which such loss may be carried" modifies "taxable income."

Rather, each of the decisions is explicitly grounded in a nonlinguistic, practical analysis of the purposes of the statute and the consequences of alternative readings (500 F.2d at 1232; 52 T.C. at 347-48). On that basis, *Chartier* stated its interpretation of Section 172(b)(2) in terms of how much of the clause *is to be taken* as modified by its final phrase. 52 T.C. at 347-48. The decision below treats the grammatical paraphrase of the matter as merely an alternative, shorthand means for stating the issue. 500 F.2d at 1232.

As will be demonstrated, and as the decision below made clear, the construction advocated by the Government would subvert the purposes for which the NOL carryover and alternative tax provisions were enacted and have been repeatedly reenacted since their appearances on the statute books in 1918 and 1942 respectively.

I. The Decision Below Effectuates the Purposes of Both of the Relevant Statutes.

Two separate sections of the Code are involved here, although only one requires construction. Each has a distinctive legislative history and functional role in the tax laws. The primary focus of Section 172 is operating losses, i.e., excess deductions of the sort which reduce ordinary income which is taxed to corporations at the rates specified in Section 11. Section 1201 functions primarily to limit the tax burden imposed on capital gains.

The design of the alternative tax is such that capital gains are taxed to corporations at the normal, Section 11 rates, only when the corporation has such a small total net income that rates lower than the 25% corporate capital gain rate apply, i.e., where the surtax rates imposed by Section 11(c) are invoked for so slight an excess of taxable income over the $25,000 surtax exemption that the total effective tax rate is less than 25%. As the Government notes in a footnote (G.Br., p. 16n.7), (a) Section 11's rate structure during the period at issue was such that the tax rate on incomes up to $25,000 was 22%, and incomes above that sum were taxed at 48%; and (b) taxation under Section 1201 was more favorable and thus applicable unless the taxpayer's total net income was less than $28,260 if all in the form of capital gain. (Section 1201 could be more favorable for incomes between $25,000 and $28,260 which included some ordinary income.)

As will be seen under this Point, the distinct purposes of Sections 172 and 1201 can only be reconciled by the position taken by the court below.

A. The Purpose of Section 172, to Mitigate the Effects of Arbitrary Annual Accounting Periods, Compels the Result Below.

Three principal subdivisions of Section 172 determine its effects. Subsection (c) defines the "net operating loss" (NOL) which may be carried to other taxable years in unambiguous terms of "gross income" and "deductions allowed":

> "(c) Net Operating Loss Defined.—For purposes of this section, the term 'net operating loss' means (for any taxable year ending after December 31, 1953) the excess of the deductions allowed by this chapter

over the gross income. Such excess shall be computed with the modifications specified in subsection (d)."

The modifications made by subsection (d) will be discussed briefly hereinafter.

The NOL is made a deduction to offset profits from better years by subsection (a):

> "(a) Deduction Allowed.—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term 'net operating loss deduction' means the deduction allowed by this subsection."

The years to which an NOL generated in one tax year may be carried are currently defined by Section 172(b)(1) as the three years preceding the loss year, for any of which it is a "carryback," and the five years next following it, for which it is a "carryover."

The order in which the NOL shall be applied to each of the eight years prescribed, and the amount to be carried onward after each application, are established by Section 172(b)(2). It is the meaning of this subsection which is in dispute between the parties here:

> "(2) Amount of Carrybacks and Carryovers.—Except as provided in subsections (i) and (j), the entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the 'loss year') shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. *The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such*

> *loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried.*" (Emphasis added.)

With respect to the italicized governing sentence, the court below properly observed that "it is impossible to find any plain meaning in the statutory language which would dispose of this controversy." 500 F.2d at 1232. Viewed separately from the legislative history and the context of its function, the bare language of the clause could be taken to mean that the NOL may be carried to each subsequent carryback or carryover year only to the extent that it exceeds "taxable income" (net ordinary income *plus* capital gain) for the year in which it has first been applied. Such a construction would serve adequately whenever the taxpayer's liability for the year of "absorption" (here 1966) has been determined under the regular tax provisions of Section 11, so that all income is taxed on the same basis and the NOL deduction will offset taxes up to the full extent of the income taxed.

However, where the "absorption" year is one in which the alternative tax applied, the Government's proposed construction results in "absorption" *without tax benefit,* since it is established that NOL deductions may not be used to offset capital gain income taxes at the alternative tax rate. *Chartier, supra* at 350-56.[16]

Respondent submits not only that the Government's proposed reading of the subsection is unconvincing on grounds of syntax (see Points II.-III., *infra*), but that this Court should reject a construction which renders the deduction in question nugatory in practice, particularly in the light of a consistent line of authority from the Tax Court

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16. The basis for the denial of the tax benefit is discussed at pages 36-38, *infra*.

and the Circuits, of which the decision below was a continuation.[17]

The first and leading decision in the area is *Chartier*, *supra*. There, in rejecting the taxpayer's contentions on the first of two consolidated petitions, the Tax Court held that when the alternative method of computing tax liability is required to be utilized in a given taxable year, a net operating loss carryback cannot be applied to reduce the the amount of capital gain subject to the alternative tax. Rather, the Court held, on the second petition, that the loss carryback is "carried" only to income subject to the partial tax at Section 11 rates and from which it may be deducted; any portion of the NOL not applied against such income to yield a tax benefit is carried onward to another year's return.

The Government was seeking in *Chartier*, as here, to have the best of both worlds—arguing, first, that in an alternative tax year the loss carryback could not be applied to reduce capital gain, and, second, that the carryback nevertheless was "absorbed" by the capital gain so as to preclude its availability as a deduction against other income in a later year. The Tax Court rejected the second Government position, concluding that the commands of the alternative tax provision and the policy underlying the net operating loss provision could encompass the former position, but, having done so , precluded the latter.

In accepting the Government's first argument—that the carryback cannot be applied to reduce capital gain in an alternative tax year—the Tax Court observed that the alternative method "creates an artificially separate tax on capital gains which ignores ordinary income and deductions." 52 T.C. at 356. At the same time, in explaining the reason why any excess carryback must then remain available to reduce income subject to the regular tax in succeeding carryback years, the court stated:

> "Provisions for applying net losses from one taxable year to other taxable years have been a part of the tax law since 1918. See sec. 204, Revenue Act of 1918. The purpose of such provisions is obviously to ameliorate somewhat the arbitrary nature of the annual accounting period, especially in the case of businesses with great fluctuations in income from year to year. Thus, section 172 is clearly designed to allow taxpayers, within the limits of the periods specified, to offset profits from one year with losses from other years *in computing their tax liabilities.*" 52 T.C. at 357 (Emphasis added.)

The court went on to say:

> ". . . in keeping with the purpose of section 172, the remaining [NOL] should be used to offset gains in other years to which it may be carried. We think that nothing in that section prohibits the carry-forward of that amount to the year ending June 30, 1962. The pertinent sentence in section 172(b)(2) is 'The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried.' We agree with petitioner's contention that the phrase 'to which such loss may be carried' modified 'taxable income' as well as 'each of the prior taxable years.' We further hold that 'taxable income' in this context (as modified by the above phrase) means that taxable income to which the loss is actually applied in computing actual tax

17. Cases cited in notes 11 and 12, *supra*.

liability. In this case, since the tax for petitioner's year ending June 30, 1962, was computed by the 'alternative' method, the only taxable income to which the loss could be carried was the $1,115.57 of ordinary income for that year." 52 T.C. at 357.

In other words, the Tax Court concluded that the policy behind Section 172 could be implemented only if any excess loss carryback in an alternative tax year, which they ruled had *no effect* in computing tax liability, must remain available as an offset against other income in subsequent years, where it could have an effect in computing tax liability. The court therefore refused to adopt the Government's almost metaphysical position that Congress' will could be done sufficiently if the deduction were taken into account in the academic exercise of computing the regular tax, notwithstanding that liability was determined under the alternative tax.

The First Circuit found the reasoning of Judge Raum to be so persuasive that it affirmed per curiam, stating: "It does not seem inappropriate to place a floor at the alternate tax, leaving unused losses to their carryover utility," and that Code Section 172(b)(2) "means that taxable income to which the loss is actually applied in computing actual tax liability." 428 F.2d at 475.

The thrust of the legislative history of the carryover provisions lends clear support to the Tax Court's views. Congress over the years has steadily expanded the tax relief available through the application of net operating losses. In the period before World War II when corporate tax rates were relatively low, ranging between 1% and 19%,[18] the need for operating loss relief was less pressing

18. The rate history for corporations is outlined in 1 J. MERTENS, THE LAW OF FEDERAL TAXATION §§2.12-.13 (perm. ed. rev. 1974).

and the congressional response was variable. With the commencement of World War II and the adoption of the Internal Revenue Code of 1939, tax rates on corporate net incomes began to increase dramatically.[19] Since 1950 the effective tax rate on corporate incomes above $25,000 has been as high as 52% and never below 40%.[20] Correspondingly, operating loss relief has been given and expanded. Appendix A sets forth the legislative history in more detail and shows that since the reintroduction of operating loss relief in 1939 the periods for carryovers and carrybacks have been expanded again and again—from the two-year carryover of 1939 until in 1958 the statute reached its present form, allowing a three-year carryback and a five-year carryover, with the stated purpose of giving nearly all corporations enough time "to absorb all of their losses against income."[21]

Thus, viewed over a span of 35 years, the Government's demand for a generally increasing share of corporate net income has been accompanied by increasing the loss availability period. In an effective way, Congress has shown that it does not intend the Government to be a partner of business only in the good years.

This Court has previously considered the function of Section 172, in *Libson Shops* v. *Koehler*, 353 U.S. 382 (1957), and emphasized the tax saving to be derived from the provision as follows:

"These provisions were enacted to ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. They were designed to permit a taxpayer to set off its lean years against its lush

19. *See* 1 J. MERTENS, *supra* note 18, §§2.12-.13.

20. 1 J. MERTENS, *supra* note 18, §§2.12-.13.

21. S. REP. No. 1881, 87th Cong., 2d Sess. 129 (1962).

years, and to strike something like an average taxable income computed over a period longer than one year." *Id.* at 386.

The Government's proposed reading of Section 172(b)(2) by which any excess of the available NOL deduction over the ordinary operating income for a year to which it has been carried is to be "absorbed" by capital gain, with *no* tax effect, and thereby eliminated as an available deduction for succeeding profit years, must be evaluated in the context of the legislative concern for achieving a fair tax on incomes which fluctuate.

B. The Purpose of Section 1201, to Tax Capital Gains at Lower Rates, Would Be Offended by a Rule Making the Realization of a Capital Gain Cause the Loss of the Benefit of an Operating Loss Carryover.

The "alternative tax," as a device for taxing the capital gain component of a taxpayer's income at a lesser rate than the ordinary income component, has existed in the Internal Revenue Code for nearly as long as operating loss carryover provisions. It first appeared in 1921[22] for individual taxpayers.

However, corporations were taxed on operating income and capital gains without differentiation until 1942, when the current pattern for corporations was established: When the alternative tax computation produces a lesser tax than Section 11, a corporation pays the total of a "partial tax" at Section 11 rates on the ordinary income component of its income, plus a 25% tax on the capital gain component. The development of alternative tax provisions is summarized in tabular form in Appendix B.

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22. Act of Nov. 23, 1921, ch. 136, §206(b), 42 Stat. 233.

It is notable that although the 1942 Revenue Act substantially reformed the existing alternative tax for individuals, it retained the then- and now-existing pattern whereby individuals, only, are *also* given favored treatment on capital gains under the regular tax provisions, in that only 50% of capital gains are deemed included in income for individual computations. See Section 1202, allowing 50% of such gain to be deducted, and Sections 1201(b)(1) and (2), removing the other (remaining) 50% from an individual's income subject to the partial tax, but including the entirety of capital gain in the amount subject to the 25% rate. Corporations have never been given such an additional benefit under the regular tax.

This fundamental difference between the capital gain treatments available to individuals and corporations is almost certainly the reason for the striking disparity between the degrees to which individuals and corporations use the alternative tax. Although it is mandatory for either variety of taxpayer when it is lower than the regular computation, in the period here at issue more than 98% of individuals reporting capital gain simply took the 50% capital gain deduction afforded by Section 1202, rather than paying under the higher (a fortiori) alternative tax computation in Section 1201(b).[23] In contrast, the mathematics of the situation compel nearly all corporations with capital gains to pay under the Section 1201(a) computation.[24]

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23. INT. REV. SERVICE, STATISTICS OF INCOME—1966, INDIVIDUAL INCOME TAX RETURNS 88 (1968).

24. In 1966, the principal year in question here, corporations paid taxes of $22 billion under the alternative tax method as compared with $12 billion under the regular tax method. INT. REV. SERVICE, STATISTICS OF INCOME—1966 CORPORATION INCOME TAX RETURNS 128-29 (1970).

The Government position, however, would subvert the policy of the alternative tax as markedly as it does that of the carryover provision: If the existence of a capital gain which invokes the presumptively favorable alternative tax computation also causes an NOL deduction to be "absorbed" without tax benefit, that capital gain, intended to be given favorable treatment of the 25% rate, will in fact deprive the taxpayer of relief from the normally higher Section 11 rates. Stated otherwise, the amount of capital gain which "absorbs" the excess NOL deduction is effectively taxed at up to 73% (!) i.e., at the sum of the 25% rate at which it is reported plus the 22% or 48% rates applicable to the ordinary income in a subsequent profit year, which the NOL would otherwise offset.

Such a result is necessarily contrary to the purpose of a statutory scheme structured to put a 25% ceiling on capital gain rates.

C. The Interpretation Sponsored by the Government would Destroy Equality of Treatment Between Taxpayers Similarly Situated Whenever a Capital Gain Occurs in a Year to Which an NOL May Be Carried.

In enacting tax legislation Congress concerns itself with the consequences of the enactment. This Court, and the lower courts, have repeated this principle with regularity. The classic case, of course, is *Gregory* v. *Helvering*, 263 U.S. 465 (1935), where the literal language of the statute would have compelled the conclusion that there was a nontaxable reorganization; but this Court refused to decide that Congress intended to legislate in a formalistic manner, saying in language not inappropriate here:

> "To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." *Id.* at 470.

This Court has always proceeded on the assumption that "[t]axation is a practical matter . . ." (*Harrison* v. *Schaffner*, 312 U.S. 579, 582 (1941)) and that the taxing statute should be so approached. And where the overall intent of Congress to reach such a practical result is evident from the entire statutory scheme, the language of a particular section has received a broader interpretation than would follow if its literal language were the only insight into the congressional meaning. *Corn Products Ref. Co.* v. *United States*, 350 U.S. 46 (1956).

Syntax is a tool, not an end, and imprecisions of statutory language must be resolved by reference to the tax consequences of competing possible interpretations. The pattern intended to be created by Section 172 is clear from the legislative history cited above, and from its practical consequences in the normal run of cases: Congress intended to lessen the inequities in tax treatment between corporations with similar aggregate incomes over a 9-year period. While Congress has not specifically tailored a separate provision to deal with the intersection of an NOL and a capital gain, any syntactical ambiguity in the one sentence chosen to cover all contingencies should be resolved in favor of effecting the overall purpose.

The extent to which the Government's position would upset the purposeful pattern can be demonstrated by an example. The most general overview which can be obtained of the operation of Section 172 is to look at a full nine-year period as summarized in Table C. (The fourth year is the loss year; the NOL generated may be carried

back to the first three years and carried over to the last five.) The assumptions made, which do not detract from the generality of the illustration, are these:

(a) The amount of the loss in the loss year (year 4) is as great as the sum of the ordinary incomes in the other eight years. Only with this assumption can the full range of the nine-year period be used. It is assumed that the ordinary income is spread ratably among the eight profit years.

(b) A substantial capital gain is realized *once* during the nine-year period, of sufficient size that whenever it occurs the alternative tax computation is used to determine taxes.

Depending upon the year in which the capital gain is experienced, nine different situations arise. The question is: In each situation what are the respective tax effects under (i) Respondent's position, and (ii) the Government's position? The results are shown in Table C on the following page.

Table C

Effect of One-Time Capital Gain on Tax Benefit Derived From Net Operating Loss (Under Assumptions Stated in Text)

Year in Which Capital Gain Occurs	Result Under Respondent's Position	Result Under Government Position
1	Entire loss is used to offset ordinary income through the whole period.	1/8 of the loss is used to offset ordinary income in year 1. Loss gives no further tax benefit. Taxpayer pays ordinary income taxes in years 2, 3, 5, 6, 7, 8 and 9.
2	Entire loss is used to offset ordinary income through the whole period.	1/4 of the loss is used to offset ordinary income in years 1 and 2. Loss gives no further tax benefit. Taxpayer pays ordinary income taxes in years 3, 5, 6, 7, 8 and 9.
3	Entire loss is used to offset ordinary income through the whole period.	3/8 of the loss is used to offset ordinary income in years 1, 2 and 3. Loss gives no further tax benefit. Taxpayer pays ordinary income taxes in years 5, 6, 7, 8 and 9.
4 (the loss year)	None of the loss can be used to offset ordinary income in other years.*	None of the loss can be used to offset ordinary income in other years.*
5	Entire loss is used to offset ordinary income through the whole period.	1/2 of the loss is used to offset ordinary income in years 1, 2, 3 and 5. Loss gives no further tax benefit. Taxpayer pays ordinary income taxes in years 6, 7, 8 and 9.
6	Entire loss is used to offset ordinary income through the whole period.	5/8 of the loss is used to offset ordinary income in years 1, 2, 3, 5 and 6. Loss gives no further tax benefit. Taxpayer pays ordinary income taxes in years 7, 8 and 9.
7	Entire loss is used to offset ordinary income through the whole period.	3/4 of the loss is used to offset ordinary income in years 1, 2, 3, 5, 6 and 7. Loss gives no further tax benefit. Taxpayer pays ordinary income taxes in years 8 and 9.
8	Entire loss is used to offset ordinary income through the whole period.	7/8 of the loss is used to offset ordinary income in years, 1, 2, 3, 5, 6, 7 and 8. Loss gives no further tax benefit. Taxpayer pays ordinary income taxes in year 9.
9	Entire loss is used to offset ordinary income through the whole period.	Entire loss is used to offset ordinary income through the whole period.

*"Loss" continues to mean the ordinary income deficit. When the capital gain occurs in year 4, there is no "net operating loss" as defined in Section 172(c).

Certainly Section 172, which was intended to equalize to a greater extent the tax burdens as between corporations with fluctuating income and corporations with stable income, should not be read to result in the anomalous situation which results under the government's view. Under that position, eight taxpayers with an identical economic performance over the 9-year period are treated in eight different ways under the tax law. Respondent's position, on the other hand, results in treating the eight different corporations who have a net operating loss in year 4 and have identical economic performance over the 9-year period in exactly the same way.

The United States emphasizes the fourth year and the fact that there is no NOL as defined in subsection 172(c) if the capital gain occurs in that year. Congress has explicitly stated its intention to exclude the corporation which experienced its capital gain in the fourth year from a net operating loss benefit. See Point III. A., *infra*. In contrast, there is nothing in the decisions or in the legislative history to justify the result which follows from the Government's position: That each of the other eight years, in which some net operating loss benefit is conferred, should be treated differently from one another. It is self-evident that the Government's position, far from rationalizing the loss carryover provisions, would introduce a major new set of irrationalities.

II. The Statutory Language Is Consistent With the Result Below.

Because the Government Brief failed to discuss seriously the congressional objectives or to provide the Court with an overview of the tax consequences which will flow from its position, it has been necessary for the Respondent to do so first. Respondent will now address the main

Government point, relating to syntax and the meaning of the words appearing in the second sentence of Section 172(b)(2):

> "The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried."

A. The Decision Below Did Not Construe the Words "Taxable Income" Standing Alone.

A substantial portion of the Government's Brief (G.Br., pp. 12-23, 26-28) is devoted to the proof of a proposition with which neither the Court below, the Tax Court (in *Chartier*), nor Respondent has disagreed: that "taxable income" means "taxable income" as defined in Section 63(a). The entire proof is directed to an extraneous non-issue. Respondent's contention is that the basic congressional objectives in enacting Section 172 require that "taxable income . . . to which the loss may be carried" in Section 172(b)(2) be read together, and that, so read, it means something quite different from what "taxable income" would mean standing alone. "Taxable income" also appears as part of a phrase in Section 1201, where it is similarly necessary that it be modified to produce the result Congress intended.[25]

In an apparent effort to make its argument appear more pertinent, the Government Brief distorts the holding of the court below on at least two occasions. At one point, it refers to "[t]he Court of Appeal's restriction of 'taxable income' to ordinary income. . ." (G.Br., p. 20), and at

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25. The version of section 1201(a) effective in 1966 assesses the partial tax on "taxable income reduced by such excess."

another to the "decision below" as "holding that the term 'taxable income' means only ordinary income in the case where the alternative tax is applicable . . ." (G.Br., p. 27). In fact, the Eighth Circuit made no attempt to construe the words "taxable income". It did approve the strict policy grounds of the decision in *Chartier*, which result in reading the sentence so that the phrase "to which the loss may be carried" modifies "taxable income", and by which the entire phrase "taxable income . . . to which the loss may be carried" can refer only to ordinary income subject to the partial tax, when the alternative tax applies. Nonetheless, the Eighth Circuit itself spoke of the matter before it in grammatical terms only as an alternative means of stating the issue to be resolved:

> Stated somewhat differently, the issue in this case is whether the last phrase of section 172(b)(2), "to which such loss may be carried" modifies "taxable income" as well as the words "prior taxable years". 500 F.2d at 1232.

This passage merely acknowledges one of the ways in which the Tax Court in *Chartier* defined the thrust of its decision. See 52 T.C. at 357-358.

B. The Statutory Language Is Consistent With the Construction Below.

Respondent submits that the court below was correct in its view that the language of the pertinent second sentence of Section 172(b)(2), is, as a matter of abstract syntax, susceptible to either of the constructions sponsored by the respective parties: the sentence is amenable to a reading whereby the phrase "to which such loss may be carried" modifies "the sum of the taxable income for each of the prior years," and is also amenable to one whereby

it modifies only "each of the prior years". However, Respondent further submits that, even apart from the reasons of policy already discussed, the statutory context in which the subject sentence appears indicates that the phrase is intended primarily to modify "taxable income".

The second sentence of the subsection is a part of Section 172 as a whole, and should be read to be consistent with the subject matter and structure of the section in its entirety. The subject matter of Section 172 is a system under which ordinary losses are spread to be deducted from available income taxed at Section 11 rates. Indeed, that system had been established under Section 172 and its predecessors for nearly a quarter of a century before the 1942 corporate alternative tax came into being[26] and first created a category of corporate capital gain to be taxed at more favorable rates. The link between operating losses and Section 11 income is one too inherent in Section 172 for one to readily accept that the language of subsection (b)(2) was not chosen to incorporate it.

Respondent's proposed construction yields a sentence readily paraphrased in pertinent part as: "taxable income to which losses may be carried and applied to reduce the tax." The only meaningful sense in which an NOL is "carried" is that it is transferred from a tax return in which there is nothing left from which it may be deducted to a tax return on which it is useful as a deduction. In other words, an operating loss is "carried" through the designated years in sequence to income from which it may be deducted. That, of course, is the meaning the Court of Appeals gave the sentence.

The Government's proposed construction, under which the sentence directs only that an NOL is carried to a

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26. See Appendix A.

year, would make the subject phrase trivial, or mere surplusage, since the preceding subsections (a) and (b)(1) have already directed that the NOL shall be carried to each of the eight years they specify. The subject of the second sentence of subsection 172(b)(2) is the "portion" of an NOL remaining to be carried to subsequent years. The deduction will not have been reduced, so that a "portion" of it remains, except in the course of being used in one of the years so defined in which it *could* be used. Thus, there is no need for subsection (b)(2) to limit the "portion" in terms of the *years* to which it may be or has been carried. A "portion" of the loss will remain only after it has been *used* in part as a deduction against taxable income.

Additional support for Respondent's view comes from Section 1201. Except where, as here, the carryover provisions also apply, the Government must surely agree that the prescribed alternative tax computations observe a hard line between (a) ordinary income to be taxed at Section 11 rates "as if this subsection had not been enacted", and (b) capital gain, to be taxed at special, preferential rates. The two categories are defined so that the ordinary income is called "taxable income reduced by the amount of such excess," since it is necessary to remove "such excess" from what is "taxable income" for Section 11 purposes, in order to segregate the "excess" for "an artificially separate tax on capital gains which ignores ordinary income and deduction". *Chartier*, *supra* at 356. Thus, Congress has shown that in contexts where the two-step alternative tax applies, the broad term "taxable income" is not usefully descriptive. Some modifier is necessary to distinguish the "partial" income still taxable at Section 11 rates after Section 1201 has segregated the capital gain for separate treatment.

Respondent submits that the modifying phrase "reduced by such excess" in Section 1201 serves to accomplish the same result as does the phrase "to which such loss may be carried", in Section 172(b)(2), each in the characteristic language reflecting the principal subject matter of its respective section. Stated otherwise, "taxable income for each of the prior years to which such loss may be carried" describes in terms of "carried" losses precisely what "taxable income reduced by such excess" describes in terms of the "excess" which is segregated for separate taxation.

If the regular tax applies in the "carry" year, it makes no difference whether the phrase "to which such loss may be carried" primarily modifies "taxable income", as *Chartier* ruled it must, or "prior taxable years", as the Government contends. When the regular tax applies, there is no ambiguity: all (net) income in the "carry" year is "taxable income . . . to which the loss may be carried," and from which it is deductible.

The difference between the parties' positions is material only when there is in the "carry" year a capital gain sufficient to invoke the alternative tax, i.e., when Section 1201 also applies. Only then does the phrase "to which such loss may be carried" serve a useful function. Then, it is necessary to conform the usage in Section 172(b)(2) to that which pertains in Section 1201: The bare term "taxable income", defined in Section 63(a) and made a tax base in Section 11(a), includes the capital gain. If the line of demarcation provided by Section 1201 is to be observed—between (1) ordinary income, to be taxed "as if this subsection had not been enacted", and (2) capital gain, which the section directs to be taxed at a single, quite different rate—it becomes necessary when the al-

ternative tax is invoked to qualify the Section 11(a) language (which otherwise serves adequately by itself when the regular tax applies). The phrase "to which such loss may be carried" serves in alternative tax years to qualify "taxable income" to conform to the meaning it has, as similarly qualified, in Section 1201.

The conclusion that the final phrase of the sentence is to be read as integral with "taxable income" in the pertinent sense is necessary to the legislative purpose, as *Chartier* and the decision below hold. As the Tax Court in *Chartier* declared, it is "not prohibited" by the statutory syntax; it is justified by the foregoing analysis of content and usage.

III. The Supposed Anomalies of the *Chartier* Rule, Advanced by the Government, Involve No Inconsistency and Do Not Support the Government Position.

Although by far the greater portion of the Government's Argument is devoted to its argument, based on syntax (see Point II, *supra*) one portion of its Point B and all of its Point C do purport to reach questions of the purpose of Section 172 as manifested in some aspects of its structure and effect.

For clarity in the following response, it is necessary as a preliminary matter to point out that the Government misuses the basic terminology of the subject matter throughout its Point C. Even the caption of the Point (G.Br., p. 28) shows the error: "Respondent Did Not Have a Loss *Carryover from 1966 to 1967*". (Emphasis added.) There is no question here of a *carryover* from 1966. The question is what carryback Respondent had from 1968

to 1967, after its 1968 NOL was carried back to 1966.[27] Subsection 172(b)(1) does not tolerate such misuse.[28]

The resulting confusion makes it uncertain whether the Government intends its arguments in this area to be taken literally (in which case they are invalid) or as policy arguments by analogy. The response in A, B, and C following considers them as arguments by analogy despite the Government's failure to acknowledge their nature as such.

A. The Computation of the Net Operating Loss Generated in a Loss Year Is Required by Express Provisions to Be Different From the Computation of "Absorption" in a Carry Year.

The Government correctly points out that a deficit in ordinary income will not produce an NOL if there is a capital gain in that year, unless the deficit is also greater than the capital gain. Section 172(c) so provides.

The Government argues from the *assumption* that Congress intended the very different language of Section 172(b)(2) to give a parallel result. G.Br., pp. 28-30. In fact, each time Congress has spoken on the subject since 1918 it has provided a different calculation of the amount of the NOL generated in the loss year than it provided for determining the amount of the NOL remaining after it has been carried to each profit year. A modern illustration of the difference is Section 172(d), which is incorporated

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27. The misuse recurs throughout Part C of the Government Brief: The five-page argument refers four times to a "carryover to 1967", three times to a loss "carried forward to 1967", and once to a loss "carried from" a non-loss year.

28. Subsection 172(b)(1) declares that a net operating loss "shall be a . . . carry*back* to each of the three taxable years preceding . . ." and a "carry*over* to each of the five taxable years following such loss".

by reference into Section 172(c): It enumerates six modifications to be made in the loss year computation, of which three are expressly made inapplicable in "carry" years by Section 172(b)(2)(A).[29]

Congress unquestionably desired to impose strict standards on the determination of whether there is a "net operating loss" in the first instance. However, once the loss threshold has been reached and a "net operating loss" comes into existence, an entirely different set of rules contained in Section 172(b)(2), reflecting different policy considerations, governs the application and absorption of that loss. The Government's reliance on Section 172(c) is thus totally misplaced.

B. The Decision Below Creates No Disparity Between Corporate and Noncorporate Taxpayers.

The last part of the Government's Point B (G.Br., pp. 27-28) is devoted to the proposition that the Tax Court position, adopted by the court below, would "accord markedly better treatment for corporations than individuals," because Section 172(d)(2)(B) requires that the Section 1202 "deduction" for individuals (50% of capital gains) not be "allowed," and thus for an individual taxpayer, "the full amount of ordinary income plus capital gains will be offset against the operating loss."

While Respondent can see no reason why corporate and noncorporate taxpayers must necessarily be treated equally (as they are not in many areas of the Code), the decision below would *not* produce different treatment for individuals than for corporations. The individual treatment

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29. Those enumerated in Sections 172(d)(1) [net operating loss deductions], (4) [various personal, non-business deductions], and (6) [deductions for dividends received by corporations].

which the Government compares to that granted corporations comes into being "under *Axelrod* v. *Commissioner*" (G.Br., p. 27), a recent decision of the Sixth Circuit which, by dictum, rejects the *Foster Lumber* decision in favor of *Mutual Assurance*. *Axelrod* thus anticipated that *both* individuals and corporations would suffer "absorption" without benefit, as the Government here proposes. In a parallel manner, the Tax Court in *Chartier* adopted the individual rule from *Weil* for corporations; and, when the occasion subsequently arose, it held that individuals would be afforded the same tax benefit as *Chartier* afforded corporations. *Sidney Axelrod*, 32 CCH Tax Ct. Mem. 885 (1973), rev'd, 507 F.2d 884 (6th Cir. 1974).

Therefore, the Government's point is no more than that *Mutual Assurance* and *Axelrod* v. *Commissioner* have created a division in the circuits.

Respondent's position clearly produces like treatment for both types of taxpayers. When the regular tax applies in the "carry" year, Section 172(d)(2)(B) functions to create *equality* between individual and corporate taxpayers. In such a year, Section 172(d)(2)(B) compensates for the difference in corporate and individual taxpayers' respective taxable incomes, which is created by the availability of the Section 1202 deduction to individual taxpayers only. Section 172(d)(2)(B) does so by providing that, for purposes of determining the amount of income which can "absorb" an NOL, that deduction shall be disregarded. Thus, in a regular tax year, the individual taxpayer's income for "absorption" purposes will include all of his capital gain, just as does a corporation's.

Under the Tax Court's view there is also equality when the alternative tax applies. As shown in *Chartier* and *Sidney Axelrod*, neither a corporation nor an individual

suffers "absorption" without benefit. The "taxable income . . . to which such loss may be carried" for either type of taxpayer, under Respondent's view, excludes the capital gain segregated for separate taxation.

Thus, there is complete equality between individual and corporate taxpayers in this regard under either the regular tax or the alternative tax.

C. *Weil*, As Extended in the Ruling on the First Petition in *Chartier* Is Entirely Consistent with *Chartier's* Ruling on the Second Petition and With the Decision Below.

A close review of the portion of the Government Brief in which *Weil* is presented as significant (G.Br., pp. 30-32) shows that the argument is no more than a restatement of the contention that the mode of computing an NOL in the loss year, as specifically prescribed in Section 172(c), should be adopted as the mode for computing the effect of the NOL deduction in a "carry" year. As such, it calls for little response in addition to that made, in Point III A., *supra*, to the broader Section 172(c) argument by which it is encompassed. (Congress did not intend parallel treatment between the "loss" and "carry" years. Nor would the Government's position create such parallelism. See Table C.) Nonetheless, some comment is made appropriate by the structure of the Government's presentation.

Weil itself held only that where the alternative tax applies to a noncorporate taxpayer, a deficit in ordinary income for the year may not be used as a deduction from the capital gain component of the year's income. That conclusion merely reflected and was compelled by a marked difference in statutory language.[30]

The Tax Court in *Weil* found a clear purpose in the alternative tax provisions to remove all capital gain from the income component on which the partial tax was levied, thereby depriving it of the position in which it could be reduced by ordinary deductions, and to cause *all* capital gain to be taxed at a distinct rate. It also found a conspicuous absence of an intent, like that manifested in the 1924 Revenue Act, to permit the capital gain so separately taxed to be reduced by any deductions.

When in its *Chartier* decision in Dkt. 838-66, the first of the corporate taxpayer's two petitions before it, the Tax Court extended *Weil* to corporations in the "carry" years, it found the provisions of Section 1201(a) to be as explicit as those of Section 117(c)(2) of the 1939 Code which it had considered in *Weil*.[31]

The Tax Court's extension of *Weil* to "carry" years effectively compelled the decision on the taxpayer's second petition regarding the following year (Dkt. 2116-67): the portion of the NOL deduction deprived of effect in 1962 by the adoption of *Weil* had either to be held preserved

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30. The difference between (a) the language of Section 117(c)(2) of the 1939 Code, stating that when the alternative tax applies, "such excess" (meaning "what we refer to as taxable capital gain," 23 T.C. at 430) shall be *eliminated* from the income component to be taxed at regular rates, but that the capital gain rate shall be applied to the entirety of "such excess," and (b) the expressly contrary language of Section 208(b) of the 1924 Act (quoted in Point III. D., *infra*).

31. "The provisions of the statute are set forth with such specificity that they admit of no such reading as that urged by the petitioner which seems to subtract from 'such excess' that portion of the carryback loss that was not absorbed in the computation of the 'partial tax' in [Section 1201](a)(1)." 52 T.C. at 351.

to achieve its intended tax effect in another year (1965), or to be obliterated without tax effect as the Commissioner argued. The latter option was recognized as contrary to the purpose of Section 172, so the Tax Court, of course, rejected the Commissioner's contention, just as this Court should reject the Government's reiteration of the same position here.

As a subsidiary aspect of its argument on *Weil*, the Government suggests (G.Br., pp. 32-33) that the decision below creates a "preferred" position for NOLD's vis-a-vis other deductions from ordinary income, since same-year excess ordinary deductions may not otherwise be given effect against the capital gain component. The Government's suggestion may be attributable to its failure to recognize that the NOLD sought by Respondent is a carryback from 1968, and is not "preferred" or otherwise related to 1966 deductions.

There is nothing remarkable about an NOLD being "carried" from year to year when same-year deductions in excess of ordinary income are left behind and lost. It is the essence of Section 172 to give net operating losses effect in other years, once the conventional deductions in the loss year reach the threshold defined in subsection 172(c). Beyond the threshold, the deductions are given a new identity, and are treated as Section 172 prescribes. *Weil*, as extended in *Chartier*, then supports Respondent's position.

For these reasons the Government's reliance on *Weil* is misplaced, and there is no logical reason why the *Weil* rule makes it "anomalous" for Respondent to apply the remainder of its 1968 NOL to its 1967 ordinary income.

D. The Government and *Mutual Assurance* Misconstrue the Legislative History Which Contributed to *Weil*.

The Government makes its first and only discussion of any aspect of the legislative history in an additional argument, which it relegates to a footnote. G.Br., p. 31 n.19.[32] There it observes that "the Revenue Acts from 1924 to 1934" permitted ordinary deductions in excess of ordinary income to be deducted from capital gain, even when the alternative tax applied in the loss year. The Government then quotes from the opinion in *Mutual Assurance* to the effect that *Chartier* creates a situation more favorable to the taxpayer than Congress had during the 1924-1934 period by allowing excess deductions in the form of NOL's to be offset against ordinary income in other years.

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32. In another footnote (G.Br., pp. 33-34n.22), the Government vaguely attempts to use the results of *Lone Manor Farms, Inc.*, 61 T.C. 436 (1974), as a basis for undermining the *Chartier* result—notwithstanding that the Tax Court found *Chartier* inapposite there. *Lone Manor Farms* illustrates the effect of having a capital gain in a "carry" year and an NOLD which creates so large a deficit in ordinary income that the regular tax computation is more favorable. When the regular tax applies the NOLD is deductible from all "carry-year" taxable income, all of which is subject to Section 11 rates. However, once so used, an NOLD becomes unavailable for subsequent years. Thus, the unqualified direction of Congress that at a certain point a taxpayer must switch from one set of tax rates to another may have abrupt secondary effects in some cases; but that circumstance provides no support for the Government's position.

The actual result in *Lone Manor Farms* would be the same under either the Government's or Respondent's position; there is no dispute that an NOLD used in determining taxes under the regular computation, when it applies, is "absorbed." The question here is one of "absorption" in a year where the NOLD has created an ordinary income deficit such that the alternative tax applies. Here, the Government position creates "absorption" with no benefit, and causes a disruption of the purposes of Section 172 by producing the results hereinbefore illustrated in Table C.

However, both *Mutual Assurance* and the Government misconstrue the significance of the legislative provision in question, which first appeared as Section 208(b)(5) of the 1924 Act,[33] and which *Weil* had interpreted correctly (pp. 36-37 and note 30, *supra*). That provision introduced a term of art, "capital net gain," which it defined as:

> ". . . the excess of the total amount of capital gain over the sum of (A) the capital deductions and capital losses, plus (B) the amount, if any, by which the ordinary deductions exceed the gross income computed without including capital gain."

This provision was reenacted by the 1926, 1928, and 1932 Revenue Acts,[34] but was absent from the 1934 and 1936 Revenue Acts which included no alternative tax in any form. No such provision was included when the alternative tax was revived for individuals by the Revenue Act of 1938. (A columnar chart showing the full capital gain and loss tax pattern from 1921 to 1942 appears as Appendix B.)

In its *Mutual Assurance*[35] opinion, the Fourth Circuit makes use of only part of the legislative history. The court reasoned as follows:

1. The structure of the alternative tax set forth in the Revenue Acts of 1924 through 1932 was such that any deficit in ordinary income would reduce the amount of capital gain subject to the second step of the alternative tax.

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33. Revenue Act of 1924, ch. 234, §208(b)(5), 43 Stat. 253.

34. Act of Feb. 26, 1926, ch. 27, §208(b), 44 Stat. 9; Act of May 29, 1928, ch. 852, §§101(a) and (b), 45 Stat. 791; Act of June 6, 1932, ch. 209, §§101(a), (c)(5), 47 Stat. 169.

35. *Mutual Assurance Soc'y* v. *Commissioner*, 505 F.2d 128, 136-38 (4th Cir. 1974).

2. When the alternative tax was revived for individuals in 1938, it contained no such provision. The Fourth Circuit refers to this as a "sharp contrast"[36] with the provision prevailing between 1924 and 1934.

Thus, concluded the Fourth Circuit, in the passage from which the Government quotes only the final sentences:

> "Such clear Congressional action in the past raises a negative inference from Congress' failure to enact similar provisions at a later date. This is particularly so where the court-fashioned remedy is more drastic than even that chosen by Congress on the prior occasion. Between 1924 and 1934, if a net operating loss exceeded net ordinary income for the year in which a deduction was allowed, the excess offset capital gains for such year, which were taxed at favorable rates. The Tax Court's remedy is a ruling that such excess will be available in the future to offset ordinary income. Thus, the Tax Court has extended a greater benefit to the taxpayer than Congress did when it expressly addressed itself to this problem on a prior occasion, and we think incorrectly so."[37]

The Court does not tell us what "negative inference" it believes may be drawn; but the only inference which may be validly drawn is that Congress intended the *Weil* result, i.e., that an ordinary loss cannot be used to reduce capital gain in making the alternative tax computation. No inference relating to loss carryovers is justified. The Fourth Circuit failed to consider that in 1938, when the alternative tax reappeared, there were no loss carryover

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36. *Id.* at 137.

37. *Id.* at 138 (footnote omitted).

provisions in the Code and there had been none since the passage of the National Industrial Recovery Act in 1933.[38] More pertinently, no inference regarding the corporate alternative tax can be drawn because there was no such tax until 1942.[39] During the periods to which the Fourth Circuit refers, corporate capital gains were taxed in the same way as operating income. Thus, correctly interpreted, the "negative inference" properly drawn was not significant to *Mutual Assurance* or here.

CONCLUSION

For the above reasons, the judgment of the Court of Appeals for the Eighth Circuit should be affirmed.

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38. See Appendix A.
39. See Appendix B.

APPENDIX A

LEGISLATIVE HISTORY OF LOSS CARRYBACK AND LOSS CARRYOVER PROVISIONS

Net operating loss carryover provisions first appeared in the Revenue Act of 1918,[1] which allowed a one-year carryback and a one-year carryforward. Senator Lenroot said in the Senate discussion of the provision,

> "It is something entirely new with reference to a taxation policy in the United States. It proposes instead of treating a taxable year as a unit to group them into two or three taxable years as the case may be."[2]

The Revenue Act of 1921[3] allowed no carrybacks but allowed carryovers to the first and second succeeding year. This provision continued until the Revenue Act of 1932 when, pressed for revenue and facing unprecedented corporate losses resulting from the depression, Congress reduced the carryover to one year only.[4] The Senate Finance Committee Report noted:

> "The net loss provision of the existing law is one of the essential protections against excessive hardships inherent in a tax based upon an arbitrary annual accounting."[5]

In the following year, however, the National Industrial Recovery Act eliminated all carryovers and carrybacks.[6]

1. Act of Feb. 24, 1919, ch. 18, §204(b), 40 Stat. 1061.
2. 57 CONG. REC. 513 (1918).
3. Act of Nov. 23, 1921, ch. 136, §204(b), 42 Stat. 231.
4. Act of June 6, 1932, ch. 209, §117(b), 47 Stat. 207.
5. S. REP. No. 665, 72d Cong., 1st Sess. 11 (1932).
6. Act of June 16, 1933, ch. 90, §218(a), 48 Stat. 209.

They were not revived until 1939, subject to a slight exception in the Revenue Act of 1938.[7]

The Revenue Act of 1939 reenacted the two-year carryover provision of the 1920's.[8] The Ways and Means Committee report[9] made it clear that the operating loss carryover provisions were intended to equalize the taxes assessed against corporations having steady incomes and against those with fluctuating earnings pictures:

> "2. Net loss carry-over.—The bill, together with the committee amendments, permits taxpayers to carry over net operating business losses for a period of two years. Prior to the Revenue Act of 1932, such 2-year carry-over was allowed. No net loss has ever been allowed for a greater period than two years. In the Revenue Act of 1932, the 2-year net loss carry-over was reduced to one year and in the National Industrial Recovery Act the net loss carry-over was entirely eliminated. As a result of the elimination of this carry-over, a business with alternating profit and loss is required to pay higher taxes over a period of years than a business with stable profits, although the average income of the two firms is equal. New enterprises and the capital goods industries are especially subject to wide fluctuations in earnings. It is, therefore, believed that the allowance of a net operating business loss carry-over will greatly aid business and stimulate new enterprises. . . . An example will show the necessity for such a provision.

7. Act of May 28, 1938, ch. 289, §26(c), 52 Stat. 467. This provision allowed a minor tax credit which at a maximum could reduce future tax rates by 2 1/2 percentage points.

8. Act of June 29, 1939, ch. 247, §122(b), 53 Stat. 867.

9. *See* H.R. REV. No. 855, 76th Cong., 1st Sess. 3, 9, 16-17 (1939).

> "Suppose a corporation, over the 3-year period 1939-41, shows the following:
>
> | | |
> |---|---|
> | Net operating loss for 1939 | $2,000,000 |
> | Normal-tax net income for 1940 | 1,000,000 |
> | Normal-tax net income for 1941 | 1,000,000 |
>
> "Looking at this 3-year period, it will be seen that the corporation has not made any profit. However, assuming a flat rate of 18 per cent, it would be required to pay a tax of $360,000 if there were no provision for a net loss carry-over. Under the bill, a corporation in such a case would not be required to pay an income tax."[10]

For the first time since the relatively short-lived World War I provision, a carry*back* of a net operating loss was allowed by the Revenue Act of 1942,[11] thus expanding the loss availability period to two years before and two years after the loss year.

Further expansion lay ahead. The Revenue Act of 1950 changed the loss availability period to one year before and five years after the loss year.[12] The House Committee Report states,

> "One effect of this change is to extend the period over which business income can be averaged from 5 to 7 years, thus reducing the tax disadvantages which occur to businesses with fluctuating incomes. Such incomes are associated with unusual business risks and occur relatively frequently among small and new businesses. Hence the extension of the averaging period from 5 to 7 years will provide a real stimulus to venture capital

10. *Id.* at 9-10.

11. Act of Oct. 21, 1942, ch. 619, §153(a), 56 Stat. 847.

12. Act of Sept. 23, 1950, ch. 994, §215(a), 64 Stat. 937.

generally and to small and new business in particular."[13]

The Internal Revenue Code of 1954[14] retained the five-year carryover and extended the net operating loss carryback from one to two years. It also made changes in the method of computing net operating losses, eliminating adjustments which had been required for the receipt of tax-exempt interest and for the excess of percentage depletion over cost depletion. The 1954 Code also significantly added to the second sentence of Section 172(b)(2) the words ". . . to which the loss may be carried." No committee or other legislative commentary on the addition of these words has been found.

The carryback period was further extended in 1958 to three years, establishing the loss availability period as it still stands today, at three years before and five years after the loss year.[15]

The Senate Finance Committee in 1962 described the current loss availability period as follows:

> "Present law provides that business losses incurred in one year can be carried back to the 3 prior years and then, to the extent not absorbed by income in those years, carried forward to the 5 succeeding years after the year in which the losses occurred. For most companies which again earn income such a period is long enough to absorb all of their losses against income."[16]

A tabulation of the significant operating loss provisions, since 1918, appears on the following page.

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13. H.R. REP. No. 2319, 81st Cong., 2d Sess. 59 (1950).

14. Act of Aug. 16, 1954, ch. 736, §172, 68A Stat. 63.

15. Act of Sept. 2, 1958, Pub. L. No. 85-866, §203(a), 72 Stat. 1678.

16. S. REP. No. 1881, 87th Cong., 2d. Sess. 129 (1962).

SUMMARY TABLE
OPERATING LOSS DEDUCTIONS

Revenue Act of	Section Number	Period Effective: Beginning After	Period Effective: Ending Prior To	Carryback and carryover (number of years): Back	Carryback and carryover (number of years): Over	Notes
1918	204	10/31/18	1/1/20	1	1	
1921	204	12/31/20	1/1/24	0	2	
1924	206	12/31/23	1/1/25	0	2	
1926	206	12/31/24	1/1/28	0	2	
1928	117	12/31/27	1/1/32	0	2	
1932	117	12/31/31	1/1/33	0	1	(1)
NIRA (1933)	218	12/31/32	1/1/38	None	None	(2)
1939	23(s) 122	12/31/39	1/1/42	0	2	
1942	23(s) 122	12/31/41	1/1/50	2	2	(3)
1950	23(s) 122	12/31/49	1/1/54	1	5	(4)
1951	23(s) 122	12/31/47	1/1/50	2	3	(5)
		Years Ending After				
1954	172	12/31/53		2	5	
1958	172	12/31/57		3	5	

Notes:

(1) Losses carried over from 1931 only.

(2) Repealed Section 117 of 1932 Act. No loss carryovers to 1933.

(3) Amendments effective for years beginning after December 31, 1940, but carryback applies only to years beginning after December 31, 1941, and no carryback is allowed to year beginning prior to January 1, 1941.

(4) Table indicates effective period of carryback and carryover provisions. Amendment effective for years beginning after December 31, 1947.

(5) Also, added special provisions for new corporations. 1953 Act added provisions for certain fiscal years.

APPENDIX B

CAPITAL GAINS AND LOSSES
TAX PATTERN 1921-1942

Revenue Act of	Alternative Tax on Long-term Gain: Individuals	Alternative Tax on Long-term Gain: Corporations	Reverse Alternative Tax on Long-term Loss: Individuals	Reverse Alternative Tax on Long-term Loss: Corporations	Long-term Demarcation	Deductibility of Long-term Loss: Individuals	Deductibility of Long-term Loss: Corporations	Deductibility of Short-term Loss: Individuals	Deductibility of Short-term Loss: Corporations
1921	12½%	None	None	None	2 years	Full, subject to reverse alternative tax.	Full	Full	Full
1924			12½%						
1934	None		None		None. Varying percentages taken into account depending upon holding period.	$2,000 No distinction between long-term and short-term loss.	$2,000	$2,000 No distinction between long-term and short-term loss.	$2,000
1938	30%		30%		18 months	Full, subject to reverse alternative tax.	$2,000 (no distinction between long-term and short-term).	Not deductible against ordinary income.	$2,000 (no distinction between long-term and short-term).
1942	25%	25%	None		6 months	$1,000 (no distinction between long-term and short-term).	None	$1,000 (no distinction between long-term and short-term).	None

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No. 74-799

In the Supreme Court of the United States

OCTOBER TERM, 1975

UNITED STATES OF AMERICA, PETITIONER

v.

FOSTER LUMBER COMPANY, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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INDEX

CITATIONS

	Page
Conclusion	14
Cases:	
Axelrod v. *Commissioner*, 507 F. 2d 884	9
Burnet v. *Sanford & Brooks Co.*, 282 U.S. 359	2
Central Tablet Mfg. Co. v. *United States*, 417 U.S. 673	5
Chartier Real Estate v. *Commissioner*, 52 T.C. 346, affirmed *per curiam*, 428 F. 2d 474	9, 11, 14
Commission v. *Nat. Alfalfa Dehydrating*, 417 U.S. 134	5
Commissioner v. *Van Bergh*, 209 F. 2d 23	11
Helvering v. *Bliss*, 293 U.S. 144	3, 6
Lewyt Corp. v. *Commissioner*, 349 U.S. 237	4
Iibson Shops, Inc., v. *Koehler*, 353 U.S. 382	4
Lone Manor Farms, Inc. v. *Commissioner*, 61 T.C. 436	6
Merrill v. *United States*, 105 Supp. 379	6
Mutual Assurance Society of Virginia Corp. v. *Commissioner*, 505 F. 2d 128	9
Pleasants v. *United States*, 305 U.S. 357	6
Reo Motors v. *Commissioner*, 338 U.S. 442	4
United States v. *Olympic Radio and Television*, 349 U.S. 232	4
Weil v. *Commissioner*, 23 T.C. 424, affirmed, 229 F. 2d 593	13, 14
Woolford Realty Co. v. *Rose*, 286 U.S. 319	3
Statutes:	
Internal Revenue Code of 1939 (26 U.S.C. 1952 ed.):	
Section 12(g)	6
Section 117(c)(2)	6
Section 122(b)(1)(A)	7
Section 122(b)(2)(A)	7
Internal Revenue Code of 1954 (26 U.S.C.):	
Section 11	9
Section 61(a)	3
Section 61(a)(3)	3

596-567—75——1

Statutes—Continued:

	Page
Section 63(a)	3, 6
Section 163	3
Section 165	3
Section 166	3
Section 172	4, 5, 7, 8, 9, 11, 13
Section 172(a)	3, 11
Section 172(b)(1)(A)(i)	11
Section 172(b)(1)(A)(ii)	11
Section 172(b)(1)(B)	11
Section 172(b)(1)(C)	12
Section 172(b)(1)(D)	12
Section 172(b)(1)(E)	12
Section 172(b)(1)(F)	12
Section 172(b)(1)(G)	12
Section 172(b)(2)	1, 3, 6, 7, 8, 11, 12, 14
Section 172(c)	2
Section 172(e)	12
Section 172(f)(2)	12
Section 172(g)(1)	12
Section 172(g)(2)(A)	12
Section 172(g)(2)(B)	12
Section 172(g)(2(B)(ii)	12
Section 172(i)	12
Section 172(j)(3)(A)	12
Section 172(j)(3)(B)	12
Section 172(j)(4)	12
Section 1212	12, 13
Section 1212(a)(1)	13
Section 1212(a)(3)	13
Section 1212(a)(4)	13
Section 1212	3
Section 1231	3

Miscellaneous:

H.R. Rep. No. 1337, 83d Cong., 2d Sess. (1954)	8
5 Mertens, *Law of Federal Income Taxation* (Rev.), Section 29.02	3
S. Rep. No. 1622, 83d Cong., 2d Sess... (1954)	8

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1. Stripped to its essentials, respondent's position in this case is that it can "carry back" a $42,000 loss incurred in 1968 to offset its 1966 taxable income of $174,000, and after that offset nevertheless continue to have $35,000 of its loss left over for use as a "carryover" to offset 1967 income. The mathematical impossibility of its argument that any part of a smaller loss figure would be available after its offset against a larger taxable income figure is made further apparent by the explicit terms of Section 172(b)(2) of the Code, which govern this case. Pursuant to that provision, the amount of a loss carryover in these

circumstances is "the excess, if any, of the amount of such loss [$42,000] over the sum of the taxable income [$174,000] for each of the prior taxable years to which such loss may be carried." After this statutorily prescribed computation, there can be no part of the loss remaining for further offset against the taxable income of other years, because there was no "excess" of the loss over the taxable income for the first year to which the loss was carried back.

Faced with this formidable statutory obstacle, respondent and the *amicus* Data Products Corporation [1] rest their argument primarily on the basis of what they perceive to be the legislative policy underlying the loss carryover provisions. In conformity with the decision below (Pet. App. B 13a), they assume that the loss carryover provisions were intended to establish a fluid system that would at all events maximize tax savings by eliminating completely the consequences of timing necessarily incident to the annual accounting system. Cf. *Burnet* v. *Sanford and Brooks, Co.*, 282 U.S. 359.[2]

[1] Unless otherwise indicated, "*amicus*" refers to Data Products Corporation.

[2] The *amicus* argues its case by the use of an unwarranted and inaccurate terminology of its own devising. In the Question Presented (Br. 2), the Summary of Argument (Br. 3) and the Argument (Br. 8 and *passim*), it refers to a "business loss" for 1968 being used as a deduction against, or to reduce the tax on, "business income." However, this usage is not employed by the Internal Revenue Code. The Code does not prescribe the nature and components of the net operating loss allowed to a corporation in terms of "business loss." Section 172(c) defines "net operating loss" simply as "the excess of the deductions allowed by this chapter over the gross income." Those deductions for respondent or any other corporate taxpayer claiming a net operating loss deduction may consist wholly or partially of such non-business items as worthless non-business loans (Section 166), deductions for non-business losses (Section 165), taxes on non-business property or transactions, or interest paid on non-business loans or obligations (Section 163).

Moreover, the net operating loss deduction (Section 172(a)) is not a deduction from "business income," but a deduction from gross income defined in Section 61(a), to arrive at the taxable income, defined in Section 63(a), which is both the base on which the tax is imposed and the base by which it is determined whether there is a net operating loss to be carried to any year after the earliest year to which it may be carried (Section 172(b)(2)). There can be no doubt that capital gains do not constitute a separate category, but are included in gross income and taxable income. See Section 61(a)(3) and *Helvering* v. *Bliss*, 293 U.S. 144. Indeed, even if the category has relevance, "business income" would include many capital gains. See Sections 1221 and 1231.

The decisions of this Court demonstrate the error of respondent's assumption that the loss carryover provisions were designed to eliminate all consequences of the timing of a loss. Each time the Court has considered claims that the loss carryover provisions applied to a given situation, it has rejected generalities couched in broad policy terms but has instead looked to whether there was explicit statutory support for the taxpayer's position. See 5 Mertens, *Law of Federal Income Taxation* (Rev.), Section 29.02. Thus, for example, in *Woolford Realty Co.* v. *Rose*, 286 U.S. 319, 326, the Court stated: "A taxpayer who seeks an allowance for losses suffered in an earlier year, must be able to point to a specific provision of the statute permitting the deduction, and must bring himself within its terms.

Unless he can do this, the operations of the current year must be the measure of his burden." Similarly, in *Lewyt Corp.* v. *Commissioner,* 349 U.S. 237, 242, the Court stated: "It is true that the computations under § 122 are designed to spread losses over a five-year period. But we are concerned with a technical concept that is being used as the basis of the formula for that reallocation." See also *United States* v. *Olympic Radio and Television,* 349 U.S. 232, 234, 235. Indeed, in *Reo Motors* v. *Commissioner,* 338 U.S. 442, 446–447, relied upon by the *amicus* (Br. 22), the Court's denial of the net operating loss deduction turned on the timing of the taxpayer's loss.

Moreover, the familiar observation in *Libson Shops, Inc.* v. *Koehler,* 353 U.S. 382, quoted by respondent (Br. 19–20) and the *amicus* (Br. 21), as well as in our opening brief (pp. 12–13), does not buttress their argument that the consequences of the timing of a loss have been eliminated by Section 172. There, the Court stated that the operating loss carryover and carryback provisions "were enacted to ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. They were designed to permit a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year" (353 U.S. at 386). This statement, however, would not even offer general support for respondent's argument without the substitution of the word "eliminate" for "ameliorate" and the omission of the qualifying

term "something like" preceding the phrase "an average taxable income * * *."

It is therefore clear that questions arising under the loss carryover provisions cannot be resolved on the basis of unsupported notions of policy but depend upon the terms of the statute. Thus, contrary to the *amicus'* argument (Br. 33), the fact that a different result would follow if the sequence of respondent's taxable years 1966 and 1967 had been inverted does not cast doubt upon the correctness of the government's position. We do not dispute that Section 172 gives significance to the timing of income and losses. But in reducing the impact of the annual accounting system, Congress was surely free to impose whatever modified timing requirements it deemed to be appropriate as a condition for the deduction of losses of one year against the income of another.

As this Court recently observed in *Commissioner* v. *Nat. Alfalfa Dehydrating,* 417 U.S. 134, 148–149, "The propriety of a deduction does not turn upon general equitable considerations, such as a demonstration of effective economic and practical equivalence. Rather, it 'depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.' *New Colonial Ice Co.* v. *Helvering,* 292 U.S. 435, 440 (1934); *Deputy* v. *DuPont,* 308 U.S. 488, 493 (1940)." See also *Central Tablet Mfg. Co.* v. *United States,* 417 U.S. 673, 690. As a result, the various examples invoked by the *amicus* (Br. 32–38) to illustrate the tax consequences of what might have

occurred under different chronological sequences are beside the point.

At all events, respondent cannot escape the fact that timing is significant even under its own position. Respondent (Br. 25–26) and the *amicus* (Br. 47) acknowledge, as indeed they must, that had respondent realized its 1966 and 1967 capital gains in 1968, it would have had an operating loss to carry to any year, and its aggregate tax would have been the same as was the sum of its taxes for 1966 and 1967 [3] (see our opening brief, pp. 28–33). Economic equivalence, therefore, is no substitute for application of the precise terms of Section 172(b)(2) to the facts of this case. Under that provision, respondent's loss must be offset against all of its "taxable income" for 1966, *i.e.*, its ordinary income and capital gains.[4]

[3] Respondent (Br. 27) and the *amicus* (Br. 19) acknowledge the correctness of the argument in our opening brief (pp. 17–23) that the meaning of "taxable income" in Section 172(b)(2) is the same as in Section 63(a), the definitional provision. However, another *amicus*, North River Insurance Company, questions that conclusion. In support of its contention, it relies upon *Merrill* v. *United States*, 105 F. Supp. 379 (Ct. Cl.). That case is distinguishable. There, the court construed the then applicable tax limitation of Section 12(g) of the 1939 Code, and held that its limitation that the tax shall not exceed 90 percent of the "net income" of individuals operated without regard to capital gains, if the Section 117(c)(2) alternative tax were applicable. However, in so concluding, the court specifically stated that its decision turned on the particularized provisions of the alternative tax which imposed a tax in lieu of the regular tax and did not constitute a deviation from the well-accepted meaning of "net income" established by this Court in *Helvering* v. *Bliss*, 293 U.S. 144, and *Pleasants* v. *United States*, 305 U.S. 357 (see 105 F. Supp. at 383).

[4] *Lone Manor Farms, Inc.* v. *Commissioner*, 61 T.C. 436, described in our opening brief (p. 33, n. 22), further illustrates that respondent's position does not eliminate the effects of timing.

2. Contrary to respondent's and the *amicus'* argument, nothing in the legislative history of Section 172 and its predecessor provisions demonstrates that Congress intended to adopt the policy of eliminating entirely the consequences of the timing of a loss. The materials to which respondent refers (Br. 18–19, 43–47) reveal the undisputed and irrelevant fact that Congress has enlarged the span of years within which a loss may be carried. Similarly, the Commitee Reports invoked by the *amicus* (Br. 21–32) speak only of the desirable goal of reducing the impact of the annual accounting system by means of the net operating loss deduction. They do not, however, discuss any of the limitations imposed by Congress on that deduction.

Although the Committee Reports do not offer any affirmative evidence of a congressional intention to eliminate considerations of timing, one aspect of the statutory history bears on the proper resolution of this case. An examination of the immediate predecessor to Section 172(b)(2)—Section 122(b)(2)(A) of the 1939 Code [5]—demonstrates that respondent's position could not have been sustained under the 1939 Code. As it existed after amendment by the Revenue Act of 1950, c. 994, 64 Stat. 906, 937, Section 122(b)(2)(A) of the 1939 Code provided, in relevant part, as follows: "* * * the carry-over in the case of the second succeeding taxable year shall be the excess, if any, of the amount of such net operating loss over

[5] Section 122(b)(2)(A) related to carry-overs. Section 122(b)(1)(A), relating to carry-backs, is phrased in the same fashion.

the net income for the intervening taxable year * * *." The term "taxable income" is used in the 1954 Code where "net income" was used in the 1939 Code.

It would therefore be impossible to reach the result for which respondent and the *amicus* contend under the 1939 Code because the phrase upon which they necessarily depend—"to which such loss may be carried"—is absent from that earlier provision (see our opening brief, p. 25, n. 17). Because the 1954 Code Committee Reports indicate that no substantive change was intended by the redrafting that produced Section 172(b)(2),[6] the result under the 1954 Code would be the same as under the 1939 Code. In both cases, there would be no excess of the 1968 loss over 1966 income available for carryover to 1967.[7]

3. Respondent (Br. 10–11) and the *amicus* (Br. 11, 32) further argue that the government's position would tax respondent on a total of $396,000 for the three-year period, 1966–1968, although respondent's aggregate income for the period was $361,000. A careful analysis of the figures demonstrates that this statement is simply inaccurate.

[6] With respect to Section 172, the Committee Reports state: "The net operating loss provisions have been rewritten both for purposes of clarity and also to incorporate several major substantive changes." H.R. Rep. No. 1337, 83d Cong., 2d Sess. A56 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 211 (1954). The substantive changes are thereafter discussed, but the provisions here in question do not appear among them.

[7] The *amicus* (Br. 43–45) argues that the Treasury Regulations offer no support for our position, and finds significance in that supposed fact. But the relevant Regulations, set forth at pp. 40–44 of the Appendix of our opening brief, are explicit in setting forth

Respondent had taxable income of approximately $174,000 in 1966 and $229,000 in 1967, and a net operating loss of $42,000 in 1968. This results in aggregate taxable income of $361,000 for the three-year period. On these figures all agree. When the 1968 net operating loss of $42,000 is carried back to 1966, respondent's taxable income for 1966 is reduced from $174,000 to $132,000. The tax on $132,000 taxable income for 1966, computed under Section 11 of the Code was (see our opening brief, p. 4) $58,200.52. Computing the tax *on the same $132,000 of taxable income,* but by the alternative method provided in Section 1201, produced the lower tax of $41,658.70 that was the ultimate tax paid for 1966. As the Sixth Circuit pointed out in *Axelrod* v. *Commissioner,* 507 F. 2d 884, 887: "Taxable income is the same regard-

the position that we support. The court below and the respondent had no doubt of that. The court of appeals stated (Pet. App. B11a): "The taxpayer concedes that its interpretation of section 172(b)(2) is counter to the position announced in Treasury Regulation 1.172–4(b)(ii), but notes that court which has considered the issue has squarely rejected the position taken by IRS." Presumably the court below thought that, in deciding for the respondent, it was holding the Regulation invalid, though it did not specifically so state. Indeed, the Fourth Circuit in *Mutual Assurance Society of Virginia Corp.* v. *Commissioner*, 505 F. 2d 128, 138, n. 21, noted that the Regulation in question was "directly contrary to *Chartier Real Estate*, [and] has been in existence since, as well as before *Chartier Real Estate*." In *Chartier Real Estate* v. *Commissioner*, 52 T.C. 346, affirmed *per curian*, 428 F. 2d 474 (C.A. 1), the Tax Court upheld respondent's position in this case. Moreover, the Sixth Circuit in *Axelrod* v. *Commissioner*, 507 F. 2d 884, 888–889, concluded its opinion by approving the pertinent Regulations as a reasonable implementation of Section 172.

less of the method of computation even though the amount of tax due may be different."

With respondent's 1966 taxable income reduced to $132,000 because of the carryback of $42,000 from 1968, and with its 1967 taxable income of $229,000 remaining unchanged, the total taxable income for the three-year period under the government's method equals $361,000 and not $396,000 as respondent and the *amicus* state. Using the more favorable method of computation of the 1966 tax, as respondent properly did, hardly increases the amount of income that was taxed.

If we take this one step further, it becomes evident that respondent and the *amicus* would reduce the taxable income for the three-year period from the agreed $361,000 to $326,000. Respondent did in fact employ the $42,000 net operating loss for 1968 to reduce its taxable income for 1966 from $174,000 to $132,000, recomputed its tax on this basis, and that recomputation was uncontested. Now it seeks further to reduce its taxable income for 1967 by $35,000 from $229,000 to $194,000. If it were successful, it would be taxed not on the $361,000 of taxable income that respondent and the *amicus* acknowledge was its total taxable income for the three-year period, but only on $326,000. Thus, respondent's assertion that the government is attempting to tax more than its aggregate taxable income for the three-year period masks its own argument in support of a tax on an amount clearly less than its aggregate taxable income for the period.

4. In our opening brief (p. 26), we pointed out that the Tax Court's construction of Section 172(b)(2) in *Chartier Real Estate Co.* v. *Commissioner*, 52 T.C. 346, affirmed *per curiam*, 428 F. 2d 474 (C.A. 1), was contrary to the overall usage of the Code. Throughout Section 172, the term "carried" has a temporal connotation of a transfer of a loss from the year in which it occurred, and would normally be taken into account, to another year.[8] Respondent (Br. 28–32) and the *amicus* (Br. 15–21) argue that the term "carried" in the statutory phrase "to which such loss may be carried" modifies "taxable income" so that the destination of the loss is an amount, "taxable income", rather than, as we believe, a taxable year.

The source of the correct usage, however, is the Code and not the dictionary definition relating to the arithmetic usage relied upon by the *amicus* (Br. 20–21). In the text of Section 172, phrases such as "carried to," "carryover to," and "carryback to" occur thirty-four times. Significantly, in every case,[9] the

---

[8] See *Commissioner* v. *Van Bergh*, 209 F. 2d 23, 25 (C.A. 2), where Judge Learned Hand explained: "The purpose of the 'carry-back,' or 'carry-over,' privilege is to allow a taxpayer some equivalent for the fact that he has not been able to reduce his tax by a loss, because he has had no income in that year against which to credit it; and the only practicable equivalent is by a fiction to treat the loss as a deduction from his income in an earlier, or a later, year."

[9] The phrases are: (1) Section 172(a): "carryovers to such year"; (2) "carrybacks to such year"; (3) Section 172(b)(1)(A)(i): "carryback to each of the 3 taxable years preceding"; (4) Section 172(b)(1)(A)(ii): "carryback to each of the 5 taxable years preceding"; (5) Section 172(b)(1)(B): "carryover to each

object of the preposition "to" is a specified year, or years, or a "which" that refers to a year or years.

Contrary to the *amicus*' argument (Br. 20), the usage of "carry" in Section 1212, dealing with capi-

of the 5 taxable years following"; (6) Section 172(b)(1)(C): "carryover to each of the 7 taxable years following"; (7) Section 172(b)(1)(D): "carryback to any taxable year preceding"; (8) "carryover to each of the 19 taxable years following"; (9) "or * * * to each of the 15 taxable years following"; (10) Section 172(b)(1)(E): "carryback to each of the 5 taxable years preceding"; (11) "carryover to each of the 3 taxable years following"; (12) Section 172(b)(1)(F): "carryback to each of the 10 taxable years preceding"; (13) "carryover to each of the 5 taxable years following"; (14) Section 172(b)(1)(G): "carryback to each of the 10 taxable years preceding"; (15) "carryover to each of the 5 taxable years following"; (16) Section 172(b)(2): "loss * * * shall be carried to the earliest of the taxable years"; (17) "loss which shall be carried to each of the other taxable years"; (We omit, and do not count, the phrase in Section 172(b)(2) that is central to this case: "the sum of the taxable income for each of the prior taxable years to which such loss may be carried"); (18) Section 172(e): "carryback or carryover to any taxable year"; (19) Section 172(f)(2): "loss * * * which shall be carried to the second preceding taxable year"; (20) "amount carried to any other taxable year"; (21) "loss which is carried to the second preceding taxable year"; (22) Section 172(g)(1): "taxable years * * * to which a net operating loss * * * may be carried"; (23) Section 172(g)(2)(A): "years * * * to which a net operating loss * * * may be carried"; (24) Section 172(g)(2)(B): "carryback to the first taxable year"; (25) "loss carried to such year"; (26) Section 172(g)(2)(B)(ii): "loss which * * * is carried to the second preceding taxable year"; (27) Section 172(i): "loss for such year which shall be carried to the third preceding taxable year"; (28) "amount carried to any other taxable year"; (29) Section 172(j)(3)(A): "carryover to the 6th taxable year following"; (30) Section 172(j)(3)(B): "carryover to the 7th taxable year following"; (31) Section 172(j)(4): "loss which may be carried—(A) to the 6th taxable year following"; (32) "amount which * * * would be

tal loss carrybacks and carryovers is exactly the same as in Section 172. In Section 1212, there are nine instances where the term "carry" is used.[10] In every case, the object of the preposition "to" is a specified year or years, or a "which" that refers to a year or years. Indeed, the two partial phrases in Section 1212 cited by the *amicus* (Br. 20) would, with more extended quotation than it has chosen to set forth in its brief, also demonstrate that "carry" relates to a transfer in time and not to an income item."[11]

5. Finally, the *amicus* (Br. 59–64) requests the Court, should it sustain the government's position, to examine and disapprove the rule of *Weil* v. *Commissioner*, 23 T.C. 424, affirmed, 229 F. 2d 593 (C.A. 6). That case held that an individual taxpayer could not, in the computation of the alternative tax, offset

carried to such 6th taxable year"; (33) "(B) to the 7th taxable year following"; (34) "amount carried to the 6th taxable year".

[10] The phrases are: (1) Section 1212(a)(1): "loss carryback to each of the 3 taxable years preceding"; (2) "loss carryover to each of the 5 taxable years"; (3) "loss for any taxable year shall be carried to the earliest of the taxable years"; (4) "loss which shall be carried to each of the other taxable years"; (5) "each of the prior taxable years to which such loss may be carried"; (6) "loss which cannot be carried back in full to a preceding taxable year"; (7) "loss which can be carried back to such preceding taxable year"; (8) Section 1212(a)(3): "loss of a corporation * * * shall not be carried back under paragraph (1)(A) to a taxable year for which"; (9) Section 1212(a)(4): "loss of a corporation shall not be carried back under paragraph (1)(A) to a taxable year".

[11] The phrases cited by the *amicus* are the sixth and seventh phrases referred to in n. 10, *supra*.

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in a single year an ordinary loss against capital gains which were subject to the flat 25 percent tax.[12] In this respect, the *amicus* disagrees with respondent's characterization (Br. 8) of *Weil* as "a long-established rule" which it does not challenge (Br. 36–38). But suffice it to say that the correctness of *Weil* was not contested by the parties in the courts below or decided by those courts. It is not an issue here. There is accordingly no occasion for this Court to issue the advisory opinion the *amicus* seeks concerning the correctness of *Weil*.

CONCLUSION

For the reasons stated above and in our opening brief, the judgment of the court of appeals should be reversed and remanded to the district court with directions to dismiss the complaint.

Respectfully submitted.

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[12] As we pointed out in our opening brief (pp. 30–31), the *Weil* rule was applied to corporations by the Tax Court in *Chartier Real Estate Co.* v. *Commissioner*, 52 T.C. 346, 350–356, affirmed *per curiam*, 428 F. 2d 474 (C.A. 1), the very case upon which respondent and the *amicus* rely for their construction of Section 172(b)(2).

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OCTOBER TERM, 1974

No. 74-799

UNITED STATES OF AMERICA, *Petitioner,*

v.

FOSTER LUMBER COMPANY, INC., *Respondent*

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF OF THE NORTH RIVER INSURANCE COMPANY, AMICUS CURIAE, IN SUPPORT OF RESPONDENT

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---

BRIEF OF THE NORTH RIVER INSURANCE COMPANY, AMICUS CURIAE, IN SUPPORT OF RESPONDENT

INTEREST OF AMICUS CURIAE

The tax liability of amicus curiae The North River Insurance Company ("North River") will be directly affected by this Court's decision in the instant case. North River currently has pending before the Internal

Revenue Service claims for refund for certain taxable years which are based, in part, on the availability of net operating losses in a carryback year subsequent to a year in which the alternative tax is imposed. The Internal Revenue Service agent auditing the claims has stated his intention to disregard the holding of the court below, two other Courts of Appeals and the Tax Court, that net operating loss carrybacks are not absorbed by capital gains in alternative tax years.

Petitioner and Respondent have consented in writing to the filing of this Brief.

PURPOSE OF BRIEF

North River does not intend to reiterate the arguments contained in the Briefs of Respondent and amicus curiae Data Products Corporation that even if the term "taxable income" as used in the second sentence of section 172(b)(2) has the meaning given to it in section 63(a), as the government argues, the government's interpretation of the sentence as a whole is incorrect.[1] While we fully agree with the Eighth Circuit's construction of the sentence, and the arguments in support thereof presented by Respondent and Data Products, the purpose of this Brief is to show that affirmance of the court below is equally appropriate on the ground that, by definition, the term "taxable income" as used in section 172(b)(2) does not include capital gains in an alternative tax year.

---

[1] The second sentence of section 172(b)(2) provides as follows:

> "The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the *taxable income* for each of the prior taxable years to which such loss may be carried." (Emphasis supplied.)

ARGUMENT

The government argues that the term "taxable income" in section 172(b)(2) must mean total taxable income as defined in section 63(a). We strongly disagree. On the basis of other statutory provisions and established judicial authority, the "taxable income" of a corporation, as that term is used in section 172(b)(2), properly means, in an alternative tax year, only that taxable income which is subject to tax in the regular manner under section 11.

Section 11 provides as follows:

> "(a) CORPORATIONS IN GENERAL—A tax is hereby imposed for each taxable year on the *taxable income* of every corporation. The tax shall consist of a normal tax computed under subsection (b) [22% of all taxable income] and a surtax computed under subsection (c) [26% of taxable income over $25,000]." (Emphasis supplied.)

If a corporation has "net long-term capital gain in excess of net short-term capital loss," however, section 1201(a) may apply. During the years here involved, that section provided:

> ". . . in lieu of the tax imposed by [section] 11 . . . there is hereby imposed a tax (if such tax is less than the tax imposed by such [section]) which shall consist of the sum of—
>
> (1) a partial tax computed on the *taxable income reduced by the amount of such excess, at the rates and in the manner as if this subsection had not been enacted,* and
>
> "(2) an amount equal to 25 percent of such excess . . . ." (Emphasis supplied.)

In *Chartier Real Estate Co.* v. *Commissioner,* 52 T.C. 346 (1969), aff'd., 428 F.2d 474 (1st Cir. 1970), the

government successfully persuaded the Tax Court that a net operating loss carryback could not be applied to reduce the long-term capital gain of a corporation in a carryback year if the section 1201 alternative tax is imposed for that year. The Tax Court upheld the government's position on the ground that section 1201 "creates an artificially separate tax on capital gains which ignores ordinary income and deduction" (52 T.C. at 357). Thus, by application of *Chartier,* with capital gains separated out and taxed on a flat, artificial basis, a loss carryback to an alternative tax year can only be applied against that reduced taxable income which is subject to tax in the regular manner under section 11.

Seeking to expand upon the *Chartier* result, the government here rejects the concept of a reduced taxable income for purposes of determining the amount of the carryback that is "absorbed" in an alternative tax year. The government contends (as it unsuccessfully contended in *Chartier*) that even though a loss carryback cannot be applied to reduce the capital gain that is separately taxed under section 1201 in the carryback year (thereby precluding the enjoyment of a tax benefit in such year), the term "taxable income" in section 172(b)(2) nevertheless should be construed so that the carryback is deemed to have been "absorbed" by the capital gain (thereby precluding the enjoyment of a tax benefit in later years as well).

The court below properly rejected this legalistic legerdemain. Rather, it correctly discerned that a loss carryback must be absorbed only by that "taxable income" which is subject to tax in the regular manner in an alternative tax year in order to give full effect to the benefits provided by Congress in both section 172 and section 1201.

A similar result was reached in *Merrill* v. *United States,* 105 F. Supp. 379 (Ct. Cl. 1952), where the Court of Claims interpreted the term "net income"—the 1939 Code term corresponding to the term "taxable income" used in the 1954 Code—to mean only that income subject to tax in the regular manner, i.e., income other than capital gain in an alternative tax year. The issue in *Merrill* involved an interpretation of the term "net income" as used in the then existing limitation on tax liability contained in section 12(g) of the 1939 Code—"90 per centum of the *net income* of the taxpayer." As here, the government contended that in an alternative tax year, the term was intended to include capital gains. The court rejected the government's contention, reasoning that to hold otherwise would have nullified the benefit Congress undertook to confer by means of the alternative tax on such gains. The court was influenced in reaching this result by the prior decisions of this Court in *Helvering* v. *Bliss,* 293 U.S. 144 (1934) and *Pleasants* v. *United States,* 305 U.S. 357 (1939), which, significantly, had reached precisely the opposite result in a different context. *Bliss* and *Pleasants* held that for purposes of computing the charitable contribution limitation, the term "net income" meant total net income, including capital gain, even in an alternative tax year.

The Court of Claims, in concluding that its decision in *Merrill* was completely consistent with the principles enunciated by this Court in *Bliss* and *Pleasants,* specifically cited the following passage in *Bliss* in support of its decision:

> "If the meaning of the Act were doubtful, we should still reach the same conclusion. The exemption of income devoted to charity and the reduction of the rate of tax on capital gains were liberal-

> izations of the law in the taxpayer's favor, were begotten from motives of public policy, and are not to be narrowly construed. Nor should the reduction in the rate of tax on capital gain, first granted in the Revenue Act of 1921, be held to circumscribe the privilege granted in the earlier Acts, and retained in later ones, with respect to charitable contributions, unless that result be plainly required by the language used. * * * " (293 U.S. at 150-151)

The Court of Claims properly construed this admonition as suggesting the necessity for an interpretation of the term "net income," in the context of the issue before it, which furthered, rather than frustrated, full enjoyment of the tax benefits intended by Congress. Since, as *Bliss* recognized, the alternative tax on capital gains is clearly a Congressionally intended benefit, and since the net operating loss provisions here involved also represent a clear liberalization of the law in the taxpayer's favor, begotten by strong policy considerations,[2] it is as appropriate here as it was in *Merrill* that the term "taxable income" be interpreted so as to exclude capital gains in an alternative tax year. To hold otherwise, as the government urges, would prevent an affected taxpayer from enjoying one or the other of those benefits solely because of accidents in timing.

Despite its assertion that the section 63(a) definition of "taxable income" applies to all provisions of the Internal Revenue Code from section 1 through section 1564, the government itself acknowledges that in

[2] The clear Congressional purpose to ameliorate the harsh consequences of the annual accounting period through the operation of section 172 is comprehensively developed in the Brief of Respondent.

some of those very provisions the term "taxable income" is given a meaning other than that provided in section 63(a). (G. Br. 18-19, n.9.) Specifically, the government refers this Court to section 832(a), dealing with non-life insurance companies such as North River. What the government fails to point out is that such companies are entitled to claim net operating loss deductions under section 172.[3] It is indisputable that the extent to which a loss carryback of such a company will be "absorbed" under section 172(b)(2) is determined, as the context requires, by reference to the company's "taxable income" as computed under section 832(a), not under section 63(a). Similarly, as applied in the context of the instant case, the term "taxable income" can and must be interpreted so as to give proper effect to the application of section 1201 in an alternative tax year.

The government next argues that if Congress had intended the term "taxable income" to be modified by the exclusion of long-term capital gains in an alternative tax year, there would have been an explicit modification to that effect contained in section 172(d). (G. Br. 18-19, n.9.) This argument plainly begs the question, since the modifications provided for in section 172(d) are modifications to whatever "taxable income" is encompassed by that term as it is intended to be used in the second sentence of section 172(b)(2). (Thus, there is no explicit modification in section 172(d) to accommodate the section 832(a) definition of "taxable income" applicable with respect to insurance companies such as North River.) If, as we contend, the term "taxable income" means, in the context of this case, only that taxable income which is subject to tax in the

[3] See section 832(c)(10).

regular manner under section 11, the capital gains in an alternative tax year are excluded by definition and no statutory modification is necessary.

The government also argues that if "taxable income" as used in section 172(b)(2) means only that taxable income which is subject to tax in the regular manner in an alternative tax year, then corporations would receive markedly better treatment than individuals. This argument is based on the erroneous assertion that the modification contained in section 172(d)(2)(B) requires an individual to "restore" 50 percent of his capital gains to taxable income, while no such requirement exists for corporations. Section 172(d)(2)(B), however, provides only that in the case of an individual taxpayer, "the [50 percent] deduction for long-term capital gains provided by section 1202 shall not be allowed." When section 1201 applies, the 50 percent deduction for capital gains under section 1202, which is allowed in a regular tax year, is automatically eliminated in the course of the alternative tax computation, and the capital gains of an individual (just like a corporation) are taxed *in full*.[4] Accordingly, no modification under section 172(d)(2)(B) is required in an alternative tax year, and no difference in treatment between individuals and corporations results if the term "taxable income" is construed as properly encompassing only that taxable income subject to tax in the regular manner in such a year.

[4] In *Mutual Assurance Society of Va. Corp.* v. *Commissioner*, 505 F.2d 128 (4th Cir. 1974), the only decision supporting the government's position on the meaning of "taxable income" in section 172(b)(2) as applied to corporate taxpayers, the majority was persuaded by an obviously erroneous interpretation of section 172(d)(2)(B), which it described as requiring an "addback" of the section 1202 deduction even in an alternative tax year. (505 F.2d at 135.)

The only case holding that an individual taxpayer's capital gain absorbs a net operating loss carryback under section 172(b)(2) in an alternative tax year is *Axelrod* v. *Commissioner*, 507 F.2d 884 (6th Cir. 1974). The Court in *Axelrod* was strongly influenced by the approach taken in *Mutual Assurance*, and assumed that its result was consistent with the treatment to be afforded corporations.

CONCLUSION

Where, as here, the benefits which Congress intended to confer under sections 172 and 1201 are so clearly established, this Court should adhere to the principles laid down in *Bliss* and *Pleasants*, as followed in *Merrill*, and interpret the term "taxable income" as used in section 172(b)(2) in a way that prevents the nullification of either of those benefits. For the reasons stated, the judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

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FOSTER LUMBER COMPANY, INC.,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit.

Brief of Data Products Corporation, as Amicus Curiae, in Support of Foster Lumber Company, Inc.

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SUBJECT INDEX

Page

The Interest of Data Products Corporation, Amicus Curiae 1

Questions Presented 2

Statute and Regulations Involved 3

Summary of Argument 3

Argument 8

I.

A Corporation's Business Loss, Allowable as a Net Operating Loss Carryback Under Section 172 of the Internal Revenue Code of 1954, Has Not Been "Carried" to a Taxable Year to the Extent That It Does Not Reduce the Taxpayer's Income Subject to Tax and Does Not Lessen the Tax Liability for That Year; Hence, the Loss Remains Available for Use as a Deduction in the Following Taxable Year 8

A. Introduction 8

B. The Decision Below Is Consistent With the Controlling Statutory Provision, the Second Sentence of Section 172(b)(2) 13

C. The Decision Below Is Consistent With the Basic Policy of Section 172 to "Average" the Tax Burden by Reducing the Harsh Consequences of the Annual Accounting Period 21

D. Under the Government's Statutory Interpretation—Which Results in a Tax Deduction Without a Tax Benefit—Accidents of Timing Are Crucial, Although Section 172 Was Enacted to Reduce the Importance of Timing 32

Page

E. The Decision Below Is Consistent, and the Government's Theory Is Inconsistent, With Section 1212(a), Enacted in 1969 to Permit Corporations to Carry Capital Losses Back for Three Years 38

F. The Administrative Practice Supports the Decision Below and Is Inconsistent With the Theory Urged Here by the Government 41

G. The Statute Should Be Interpreted to Have a Substantive Result—Not One Which Is Purely Formalistic 45

H. The Government's Contentions, Urged in Support of a Restrictive Interpretation of Section 172, Will Not Survive Analysis 47

1. The government's insistence on "parallel treatment" for the year in which the loss arose and the years to which a net operating loss is carried conflicts with an express, consistent congressional policy of treating these years differently 47

2. The government's assertion that corporations would receive "markedly better treatment" than individuals under the decision below is not warranted 51

3. The government is wrong in contending that the decision below entails an improper "pyramiding" of tax benefits 54

4. The repeal of the 1924-34 rules regarding computation of the alternative tax does not provide support for the government's construction of Section 172(b)(2) 55

Page

II.

The Tax Court's Construction of Technical Provisions of the Internal Revenue Code, Unless Clearly Erroneous, Should Be Given Great Weight by the Federal Courts of General Jurisdiction 57

III.

If the Decision Below Is Reversed, the Principle Decided in *Weil* v. *Commissioner*, as Applied in the *Chartier* Case, Should be Rejected 59

Conclusion 64

INDEX TO APPENDICES

Appendix A. Statute and Regulations ....App. p. 1

Appendix B. .....App. p. 15

TABLE OF AUTHORITIES CITED

Cases — Page

Arrowsmith v. Commissioner, 344 U.S. 6 (1952) .. 58

Axelrod v. Commissioner, 32 T.C.M. 885 (1973), rev'd 507 F.2d 884 (5th Cir. 1975) 51, 54

Chartier Real Estate Co., Inc. v. Commissioner, 52 T.C. 346 (1969), aff'd 428 F.2d 474 (1st Cir. 1970) .....15, 16, 17, 18, 19, 20, 29, 30 .....32, 41, 46, 51, 53, 56, 58, 59, 60, 61

Continental Equities Inc. v. Commissioner, 33 T.C.M. 812 (1974), pending on appeal in the Fifth Circuit 18

Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1956) 46

Data Products Corp. v. United States, decided December 27, 1974 by the Ninth Circuit in an unpublished opinion, No. 74-3341 18

Dobson v. Commissioner, 320 U.S. 489 (1943) 59

Gregory v. Helvering, 293 U.S. 465 (1935) 45

Harrison v. Schaffner, 312 U.S. 579 (1941) 46

Libson Shops, Inc. v. Koehler, 353 U.S. 382 (1957) 21, 24, 62

Lone Manor Farms, Inc. v. Commissioner, 61 T.C. 436 (1974), aff'd by unpublished opinion, 510 F.2d 970 (3rd Cir. 1975) 57, 58

Meissner v. United States, 364 F.2d 409 (Ct. Cl. 1966) 63

Muniz v. Hoffman, decided June 25, 1975 46

Mutual Assurance Society of Virginia Corp. v. Commissioner, 505 F.2d 128 (4th Cir. 1975) 18, 55, 56, 58

Page

Naegle v. United States, decided August 6, 1973 (D. Minn.) pending on appeal in the Eighth Circuit, No. 73-1921 18

Olympic Foundry Co. v. United States, 493 F.2d 1247 (9th Cir. 1974) 18

Read v. United States, 320 F.2d 550 (5th Cir. 1963) 62, 63

Reo Motors, Inc. v. Commissioner, 338 U.S. 442 (1950) 22, 24

Statler Trust v. Commissioner, 361 F.2d 128 (2d Cir. 1966) 61, 62

United Housing Foundation v. Forman, decided June 17, 1975 46

United States v. Foster Lumber Co., 500 F.2d 1230 (8th Cir. 1974) 18, 21

Weil v. Commissioner, 23 T.C. 424 (1954), aff'd 229 F.2d 593 (6th Cir. 1956) .....15, 17, 19, 56 .....59, 60, 61, 62, 64

Statutes and Regulations

Internal Revenue Code of 1939

Sec. 23(s) 22

Sec. 122 22

Internal Revenue Code of 1954

Sec. 11 .....14, App. A, p. 1

Sec. 46(b) 21

Sec. 63(a) .....6, 16, 18, 19, 20, App. A, p. 1

Sec. 170(d) 22

Sec. 172 .....3, 4, 8, 10, 11, 12, 13, 16, 20, 21, 30 ....32, 35, 40, 41, 47, 48, 49, 58, 61, App. A, pp. 2-6

Sec. 172(a) 14

Sec. 172(b) 2, 14

	Page
Sec. 172(b)(2)	3, 4, 5, 6, 13, 15, 18, 19, 20, 29, 30, 32, 35, 36, 37, 40, 41, 42, 43, 44, 48, 49, 53, 55, 57, 60
Sec. 172(c)	13, 47, 48, 49
Sec. 172(d)	13, 48
Sec. 172(d)(2)(B)	51, 52, 53, 54
Sec. 172(d)(4)	49
Sec. 172(d)(5)	49
Sec. 172(d)(6)	49
Sec. 243(a)	49
Sec. 402(e)	22
Sec. 453	22
Sec. 455	22
Sec. 456	22
Sec. 565	22
Sec. 691(c)	62, 63
Sec. 904(d)	22
Sec. 904(e)	22
Sec. 1201	8, 10, 57, 58, App. A, pp. 6-7
Sec. 1201(a)	2, 14, 52
Sec. 1201(a)(1)	64
Sec. 1201(a)(2)	15, 61
Sec. 1201(b)	51, 52
Sec. 1202	52, 53, App. A, p. 7
Sec. 1211(a)	38
Sec. 1212	22, App. A, pp. 7-9
Sec. 1212(a)	38
Sec. 1212(a)(1)	20, 40, 41
Sec. 1212(a)(1)(A)	38, 39
Sec. 1212(a)(1)(A)(ii)	40
Sec. 1212(a)(1)(B)	38
Sec. 1301	22
Sec. 1341	22
Sec. 1342	22
Sec. 6214(b)	58
Sec. 7482(a)	59

	Page
Revenue Act of 1924, c. 234, Sec. 208(a)(5), 43 Stat. 253	56
Revenue Act of 1939, c. 247, Sec. 211, 53 Stat. 862	22
Revenue Act of 1942, c. 619, Sec. 150, 56 Stat. 798	26
Revenue Act of 1950, c. 994, 64 Stat. 900	27
Revenue Act of 1951, c. 521, 65 Stat. 452	27
Tax Reform Act of 1969, Public Law 91-172, 83 Stat. 487	29, 41
Technical Changes Act of 1953, c. 512, 67 Stat. 615	27
Technical Amendments Act of 1958, Public Law 85-866, 72 Stat. 1606	29
Treasury Regulations on Income Tax Under Internal Revenue Code of 1939.	
Reg. 111, §29.122-1	28
Treasury Regulations on Income Tax Under Internal Revenue Code of 1954	
Reg. §1.172-1	App. A, pp. 10-12
Reg. §1.172-2	App. A, pp. 12-13
Reg. §1.172-4	App. A, pp. 13-14
Reg. §1.172-4(b)(1)(ii)	44
Reg. §1.172-5(a)	44
Reg. §1.172-5(a)(1)	44
Reg. §1.172-5(a)(3)	44
Reg. §1.1212-1(a) Ex. (3)-(6)	45
Reg. §1.1502-11(a)(1)	43
Reg. §1.1502-12	43
Reg. §1.1552-1	43

Miscellaneous

Page

Branda, Net Operating Losses and Capital Gains—Some Bizarre Consequences of the Alternative Tax Computation, 28 Tax Lawyer 451 (1975) .. 58

Business-Loss Offsets, Hearings on Proposed Revisions of the Internal Revenue Code, Part 5, p. 3784 (1947), in House Committee on Ways and Means, 80th Cong., 1st Sess. 24, 25

H. R. Conf. Rep. No. 2543, 83rd Cong., 2nd Sess. 30 (1954) 28, 48

H. R. Conf. Rep. No. 2632, 85th Cong., 2nd Sess. (1958-3 C.B. 1188) 30

H. R. Conf. Rep. No. 91-782, 91st Cong., 1st Sess. (1969-3 C.B. 644) 30

H. R. Rep. No. 855, 76th Cong., 1st Sess. (1939-2 C.B. 504) 22, 23, 31

H. R. Rep. No. 2333, 77th Cong., 1st Sess. (1942-2 C.B. 372) 27

H. R. Rep. No. 2319, 81st Cong., 2nd Sess. (1950-2 C.B. 380) 27

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H. R. Rep. No. 894, 83rd Cong., 1st Sess. (1953-2 C.B. 508) 28

H. R. Rep. No. 1337, 83rd Cong., 2nd Sess. 27 (1954) 28, 37, 48

H. R. Rep. No. 775, 85th Cong., 1st Sess. (1958-3 C.B. 811) 29

H. R. Rep. No. 91-413, 91st Cong., 1st Sess. (1969-3 C.B. 200) 30

Remarks of Hon. Potter Stewart, 28 Tax Lawyer 451 (1975) 58

Page

Rev. Rul. 66-91, 1966-1 C.B. 54 .....21, 41, 42, 43

S. Rep. No. 1631, 77th Cong., 2nd Sess. (1942-2 C.B. 504) 27

S. Rep. No. 2375, 81st Cong., 1st Sess. (1950-2 C.B. 483) 27

S. Rep. No. 781, 82nd Cong., 1st Sess. (1951-2 C.B. 458) 27

S. Rep. No. 685, 83rd Cong., 1st Sess. (1953-2 C.B. 526) 28

S. Rep. No. 1622, 83rd Cong., 2nd Sess. 31 (1954) 28, 48

S. Rep. No. 1983, 85th Cong., 2nd Sess. (1958-3 C.B. 922) 29, 31

S. Rep. No. 91-552, 91st Cong., 1st Sess. (1969-3 C.B. 423) 30

Tax Management Memorandum 75-12, June 9, 1975 37

The Nature and Tax Treatment of Capital Gains, National Bureau of Economic Research, New York, Lawrence Seltzer 55

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IN THE

Supreme Court of the United States

October Term, 1974
No. 74-799

UNITED STATES OF AMERICA,

Petitioner,

vs.

FOSTER LUMBER COMPANY, INC.,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit.

Brief of Data Products Corporation, as Amicus Curiae, in Support of Foster Lumber Company, Inc.

The Interest of Data Products Corporation, Amicus Curiae.

Data Products Corporation will be directly affected by this Court's decision in the present case. The Court of Appeals for the Ninth Circuit, considering an identical issue, affirmed a summary judgment of the District Court, holding that Data Products Corporation was entitled to a refund of taxes in excess of $150,000 for the year 1970. Affirmance by this Court of the decision below in the Foster Lumber Co. case will not only lead to affirmance of the decision of the Court of Appeals for the Ninth Circuit, but it will also confirm the right of Data Products Corporation

to apply more than $5,000,000 of unused carryback losses against the taxes that would otherwise be imposed on its business income in other years—an application which would be completely lost if the views of the government were to prevail.

The United States has filed a petition for a writ of certiorari to review the decision of the Ninth Circuit in favor of Data Products Corporation (No. 74-996, October Term, 1974). This Court has not acted on the petition.

Recognizing the direct interest of Data Products Corporation in the issue to be considered by this Court in the present case, the United States and Foster Lumber Co. have each consented, in writing, to the filing of a brief *Amicus Curiae*.

Question Presented.

Foster Lumber Co., the taxpayer, incurred a business loss in the year 1968. In accordance with I.R.C. Section 172(b), a portion of the loss served as a deduction to reduce the corporate income tax on its ordinary business income earned in 1966. During the year 1966, the taxpayer also had a capital gain, the tax on which was determined under the so-called alternative method prescribed by I.R.C. Section 1201(a); no part of the 1968 net operating loss served to reduce the tax on the taxpayer's 1966 capital gains.

The question is whether the court below was correct in concluding that the portion of the 1968 business loss, not deductible in prior years and not deductible in computing the 1966 tax on capital gains, was still available as a deduction against the corporation's 1967 business income.

Statute and Regulations Involved.

The pertinent provisions of the statute and Treasury Regulations involved are set forth in Appendix A, *infra*.

Summary of Argument.

1. Where a business loss is incurred, it is available as a deduction against the business income of another year under the net operating loss provisions of §172 of the Internal Revenue Code. The court below correctly held that such loss has not been "carried" to an earlier year when there was a capital gain taxed at a flat rate under the alternative tax and that, consequently, the loss is still available as a deduction in the year of ordinary business profits.

Specifically, under the decision below, the business loss which Foster Lumber Co. experienced in 1968 was, for the most part, available as a deduction, to offset the business profits of 1967. Contrary to the government, the 1968 loss had not been "carried" to 1966 (except to the extent that there was a small amount of business income in 1966) when there was a capital gain subject to a flat rate of tax, since all agree that the tax on such capital gain was not reduced by the existence of the 1968 loss. Consequently, it was still available in 1967.

2. The court below, which applied principles long followed by the Tax Court, was correct in its construction of the statute and in rejecting the contention that there could be a deduction which did not result in a tax benefit, which is the theory espoused by the government. The decision of the court below is not only warranted by the language of §172(b)(2) (even though the statute is capable of more than one construction)

but is buttressed by every existing aid to ascertaining the legislative intent. The government, in urging a contrary construction, points to little, aside from the words of an ambiguous Code Section, to justify the conclusion that the statute achieves only an abstract objective of reducing taxable income, rather than a meaningful result of reducing taxes; what little it relies on is demonstrably wrong.

3. The decision below gives substantive meaning to §172(b)(2), for it carries out the announced congressional policy that underlies all of §172, namely, an averaging of the tax burden where business results are sporadic and putting competitiors on an even footing, even though the income of one is more volatile than that of another. It also gives simultaneous effect to the congressional policy which views capital gains as being separate from ordinary business earnings, and believes that the economy can best be served by taxing these two kinds of income differently. The legislative history, moreover, confirms the conclusion that both policies were intended by Congress to be adhered to, rather than having one of them being undermined, as would be true if the government's view were to prevail.

4. The decision below results in §172(b)(2) being applied in a meaningful way, *i.e.*, affording a deduction which results in a tax reduction, rather than having it serve only as an abstract deduction from taxable income in some work sheet, which is never reflected in the form of a tax benefit. The assumption of the court

below that Congress was acting substantively, not purely formalistically, accords with well settled principles.

5. The decision below applies the statute so that sheer accidents of timing do not control the ultimate tax results and it avoids the curious consequence which would follow under the government's view where a reduction in tax depends upon the happenstance of which came first—the capital gain or the business income. §172(b)(2), as interpreted by the court below, results in a uniform tax burden regardless of this particular sequence, which becomes irrelevant, as it should. It also avoids the bizarre result, which would otherwise follow under the government's thesis, where a later capital loss would not only eliminate a prior tax on capital gains, but would also eliminate a prior tax on business profits—the latter results being contrary to the expressed intention of Congress.

6. The one available insight into the administrative practice reveals a construction of §172(b)(2) which is contrary to the present litigating position of the government. Indeed, during a period of more than thirty years, when they could have done so, the Treasury Regulations have never expressed the conclusion only recently adopted as the government's litigating position. Further, aside from whether the government has ever disclosed that position to Congress, the fact is that Congress, despite the opportunity to disavow the Tax Court's view of the statute (which was also the view embraced by the court below), not only failed to do so but

achieved a parallel result when it enacted capital loss carryback provisions for corporations in 1969.

7. Since the ultimate issue depends on an interpretation of narrow, technical provisions of the Internal Revenue Code, and does not require the applicability of broad, basic principles in the administration of the tax law, the federal courts should rely heavily on the expertise of the Tax Court which is constantly immersed in all the details of the taxing statute. If the Court of Appeals for the Fourth Circuit had relied more heavily on what the Tax Court had already, and repeatedly decided, the present conflict in decisions would not have arisen and there would have been no occasion for this Court to decide the particular, narrow problem here presented.

8. The government is wrong in contending that the court below gave "taxable income" in §172(b)(2) a different meaning than is its definitional meaning in §63(a). Neither it nor the Tax Court did so. Actually, it is the "carried" language of §172(b)(2) which leads to the conclusion that a net operating loss has not been carried to a year when it does not reduce the taxable income on which the tax is imposed. The government's argument also embraces other erroneous premises, such as (a) that Congress intended parallel treatment for the loss year and the years to which a loss is carried, (b) that the decision below would result in better treatment for corporations than for individuals, and (c) that there is an improper pyramiding

of benefits when the Internal Revenue Code is applied in such a way as to give effect to two different policies for which Congress has made separate provision.

— — —

9. In the event that this Court should reverse the decision below, we urge that there be a reconsideration of one of the premises assumed by the court below, and on which the Tax Court has traditionally proceeded, namely, that a net operating loss does not reduce the amount of capital gains or the tax thereon, where the alternative tax is used. We contend that if the government's position is adopted and this Court holds that a net operating loss has been carried to a year where there are capital gains subject to the alternative tax, the premise that the tax on such capital gains is not reduced by the net operating loss can no longer survive.

ARGUMENT.

I.

A Corporation's Business Loss, Allowable as a Net Operating Loss Carryback Under Section 172 of the Internal Revenue Code of 1954, Has Not Been "Carried" to a Taxable Year to the Extent That It Does Not Reduce the Taxpayer's Income Subject to Tax and Does Not Lessen the Tax Liability for That Year; Hence, the Loss Remains Available for Use as a Deduction in the Following Taxable Year.

A. Introduction.

The question before the Court involves an interplay between two provisions of the Internal Revenue Code of 1954—§172, permitting taxpayers to carry a business loss from the year of the loss to certain other taxable years, where it may be used as a deduction; and §1201, imposing an "alternative tax" on taxpayers with net long-term capital gains[1] if the tax so computed is less than the tax computed under the regular method. Each provision reflects distinct congressional policy decisions regarding separate problem areas in the tax law.

Although the statutory provisions are complicated, the issue itself can be phrased in simple, nonstatutory language. Foster Lumber Co., the taxpayer before the Court, suffered a business loss of about $42,000 in

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[1]Like the government (Br. p. 15, n. 5), we use the term "net long-term capital gain" as a convenient substitute for the more cumbersome statutory phrase, viz., the "excess" of "the net long-term capital gain" over "the net short-term capital loss." See §1201.

Except where indicated, statutory references are to the Internal Revenue Code of 1954, as amended.

1968. It carried that loss back to 1966, a year in which it had business income of about $7,000 and net long-term capital gain of about $167,000. The 1968 business loss was applied in 1966 to wipe out the taxpayer's $7,000 of business income, producing a refund of the tax that had been paid on this amount. The tax on the taxpayer's 1966 net long-term capital gain, however, was unaffected by the 1968 loss, for reasons that will be explained *infra,* p. 15. The taxpayer therefore sought to carry $35,000 of its 1968 loss (*i.e.*, the original loss of $42,000, less the $7,000 that served to reduce its 1966 taxes) to 1967, a year in which it had about $114,000 of business income.

The court below, following the rule consistently adhered to by the Tax Court and (at that time) by all other Courts of Appeals, affirmed the district court. It agreed with the taxpayer that its 1968 loss could be carried to 1967, except to the extent ($7,000) that it was used to offset its 1966 business income, and that it was not further reduced by the 1966 long-term capital gains, since the tax paid on the capital gains was in no way diminished by the 1968 loss.

The government argues, to the contrary, that even though the 1968 loss did not diminish the tax on the 1966 long-term capital gains, it was nonetheless "absorbed" by such gains, so that there is no remaining loss to be carried to and deducted in 1967 and so that the rest of the 1968 loss was "used" in 1966 even though it resulted in no tax benefit.

These competing claims, as we will show, rest on alternative interpretations of ambiguous statutory language. After observing that "it is impossible to find any plain meaning in the statutory language that would dispose of the controversy" and that the taxpayer and government each offered "a plausible reading of [the statutory language] on its face," the court below rejected the government's construction and held that "the basic policy considerations underlying Sections 1201 [relating to the alternative tax on long-term capital gains] and 172 [providing for the carryover of net operating losses] decisively support the result reached by the district court." *United States v. Foster Lumber Co.*, 500 F.2d 1230, 1232 (8th Cir. 1974).

Before turning to the statutory language itself, we wish to illustrate for the Court the practical consequences of the competing claims of the parties, since it is only by examining these results that one can determine which interpretation will best serve the legislative objectives.

First, the relevant facts, related above, are set out in Table A.

TABLE A

Facts in *United States v. Foster Lumber Co.*
(Dollar amounts rounded off to nearest $1,000)

Year	Ordinary Income	Long-Term Capital Gain	Total Income
1966	$ 7,000	$167,000	$174,000
1967	114,000	115,000	229,000
1968	(42,000)	—0—	(42,000)
Total	$ 79,000	$282,000	$361,000

As indicated by the bottom line of Table A, the taxpayer's net economic gain during the period 1966-68 was $361,000—its net total income. This is the amount that will be taxed, after carrying the 1968 loss back to 1966 and 1967, if the decision below is upheld by this Court. Moreover, the appropriate rates are applied to this economic gain: the taxpayer's $79,000 of business income is taxed at the regular rate, and its $282,000 of capital gain is taxed at the capital gain rate. By contrast, the government asserts that the amount of income to be taxed is $396,000—$35,000 more than the taxpayer's net economic gain. The results of these competing interpretations of §172 are compared in Table B.

TABLE B

Amounts Taxed After Carryback of Net Operating Loss,
Under (A) Decision Below and (B) Government's Theory

	A. Decision Below			B. Government's Theory		
Year	Ordinary Income	Long-Term Capital Gain	Total	Ordinary Income	Long-Term Capital Gain	Total
1966	—0—	$167,000	$167,000	—0—	$167,000	$167,000
1967	79,000	115,000	194,000	114,000	115,000	229,000
1968	—0—	—0—	—0—	—0—	—0—	—0—
Total	$79,000	$282,000	$361,000	$114,000	$282,000	$396,000

If the bottom line of Table B is compared with the bottom line of Table A, it is readily apparent that the amounts actually subject to tax under the decision of the court below correspond precisely with the economic results of the taxpayer's operations; the government's theory, if accepted, would result in taxing $35,000 more income than was actually realized during the period. The disparity reflects the government's claim that the 1968 business loss was "absorbed" by the 1966

capital gain or, as the government sometimes puts the point, was fully "used" in 1966, even though it results in no tax benefit since neither the amount of capital gains subject to tax nor the tax payable thereon was reduced in any way by this alleged "absorption" or "use" of the 1968 loss. As we will point out (fn. 11, pp. 28-29, *infra*), the manner in which the government uses these terms, which do not appear in the Internal Revenue Code itself, serves to obscure rather than illuminate the issue to be decided by this Court.

Not only would the government's interpretation of §172, if accepted, tax more than the taxpayer's economic gain during the period 1966-68 in the circumstances that happen to be before the Court; it would also make the results depend on sheer accidents of timing. For, under the government's view, the so-called "absorption" without tax reduction takes place only if, in the carry years, the capital gain *precedes* the year or years of business profits; if the capital gain *coincides with* or is *subsequent to* business profits, the "absorption" will result in a tax reduction.

For example, if the taxpayer's 1966 and 1967 business income had been received in 1966 rather than split between two years, or if its 1966 and 1967 long-term capital gains had been received in 1967, it would clearly have been entitled to apply its 1968 business loss in full against its 1966-67 business income. As we shall show (*infra*, pp. 32-40), these are only some of the bizarre tax results which arise under the government's interpretation of §172. By contrast, the decision of the court below avoids these accidents of timing, for under its ruling, the result is the same whether the capital gain came first or later in the carryback years. Its decision achieves the legislative purpose of §172, which

was enacted to achieve something comparable to an average taxable income over a period of time. See Point I-C, *infra*, pp. 21-26.

We will show that the government's interpretation is not warranted by the statutory language, is contrary to the congressional policy in enacting §172, leads to absurd results in this case and in other situations, conflicts with the only Internal Revenue Service ruling in point, produces an insupportable result when combined with an important 1969 amendment to the Internal Revenue Code, and assumes a lack of expertise by the Tax Court which has consistently interpreted these complicated statutory provisions in the same manner as did the court below.

B. The Decision Below Is Consistent With the Controlling Statutory Provision, the Second Sentence of Section 172(b)(2).

1. We turn to the relevant provisions of the Internal Revenue Code of 1954, as amended. §172(c) defines "net operating loss" (hereafter NOL) as follows:

> "For purposes of this section, the term 'net operating loss' means (for any taxable year ending after December 31, 1953) the excess of the deductions allowed by this chapter over the gross income. Such excess shall be computed with the modifications specified in subsection (d)."

The modifications required by §172(d) will be examined at a later point (*infra*, pp. 48-50).

Net operating losses, as defined by §172(c), are carried from the loss year back to certain earlier years ("carrybacks") and forward to certain later years

("carryovers"), where they become available as net operating loss deductions, pursuant to the rules of §172(a) and (b). For convenience, we shall sometimes refer to the "carryback" years and the "carryover" years, in totality, as the "carry years."

An NOL is thus carried back to the 3 years immediately preceding the loss year and then forward to the 5 years immediately following that year in strict chronological order. The NOL must be used, to the extent possible, in the earliest year to which it is carried. Any balance is then carried to the next succeeding year, and so on, until the loss is exhausted by use or by expiration of the 9-year statutory cycle. When carried back to years preceding the loss year, an NOL ordinarily generates a refund of taxes already paid; when it is carried forward to years following the loss year, it is recorded on the tax return like any other deduction, and hence it reduces the tax to be paid when the return is filed.

Foster Lumber Co. was subject in 1966 to the so-called "alternative tax" under §1201(a), consisting of two components—a "partial tax" computed at the regular corporate tax rates under §11 on its net ordinary income, plus an amount equal to 25% of its net long-term capital gain. The carryback of the taxpayer's 1968 NOL to 1966 reduced its net ordinary income for that year from $7,000 to zero. Thus, its "partial tax," as recomputed under §1201(a), was also zero.

Since only $7,000 of the taxpayer's 1968 NOL was needed to wipe out its $7,000 of net ordinary income for 1966, it would seem at first blush that the $35,000 balance of the 1968 NOL (*i.e.*, $42,000 less $7,000) could be used to reduce the taxpayer's 1966 long-term

capital gain from $167,000 to $132,000 in computing the second component of the alternative tax under §1201(a)(2). But the Tax Court has already held to the contrary, namely, that the amount of capital gain subject to tax under the alternative computation is not to be reduced by the amount of any operating loss, regardless of whether the loss and the capital gain take place in the same year (*Weil v. Commissioner*, 23 T.C. 424 (1954), aff'd 229 F.2d 593 (6th Cir. 1956)) or the loss takes place in one year and the capital gain is in a carryback year (*Chartier Real Estate Co., Inc. v. Commissioner*, 52 T.C. 346 (1969), aff'd 428 F.2d 474 (1st Cir. 1970)). For purposes of our primary position, we accept this principle which, for convenience, will be referred to as the *Weil* principle.

2. The question of how much, if any, of the taxpayer's 1968 NOL was still available in 1967, after having reduced the 1966 business income of $7,000 to zero—the ultimate issue in the case—is governed by §172(b)(2) which provides, in pertinent part, as follows:

> ". . . the entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the 'loss year') shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried."

Admittedly, so far as the precise problem presented here is concerned, the statutory language is not a

model of clarity. As the court below observed, either of two interpretations is plausible. The statute could mean, as the government argues, that so long as the taxable income (as defined by §63(a)) of any carry year is reduced,[2] the loss is, to that extent, "carried" to that year and is no longer available as a deduction in any other year, even though the "reduction" in taxable income in such earlier year is a pure abstraction and does not under the *Weil* principle reduce the tax burden of that year because it was a capital gain year in which the alternative method is to be used. But Congress could also have meant, as we contend and the court below held, that a loss has not been "carried" to an earlier year, and hence is still available as a deduction in a subsequent taxable year, to the extent it does not reduce the amount of taxable income which is subject to tax or diminish the tax burden of such earlier year—in short, if it does not produce a tax benefit.

This precise problem of statutory construction first arose in the United States Tax Court as the second issue in *Chartier Real Estate Co., Inc. v. Commissioner*, 52 T.C. 346 (1969) (where the *Weil* principle was also reaffirmed). For convenience, we shall sometimes refer to the rule there established as the *Chartier* principle. There, the government contended, as it does here, that even though the operating deficit of the loss year, and the NOL which it engendered, did not reduce the amount of capital gains subject to tax or diminish the tax on such capital gains in the carryback

[2]As a matter of statutory definition under §63(a), and under §172, the NOL does reduce "taxable income" in a carry year where there are capital gains taxed under the alternative tax. This reduction in taxable income appears only in an amended tax return or in an accountant's work sheet, but will not reduce the tax on the capital gains because of the *Weil* principle.

year, nonetheless, the net operating loss deduction was "absorbed" in the carry year in which there was a capital gain, since it reduced "taxable income" (and nothing else); hence, so it was contended, the loss could no longer be carried to the next profitable year despite the fact that it produced no tax benefit. This contention was rejected.

Since *Chartier* was the first time that this issue was considered, and since the Tax Court there also affirmed the *Weil* principle, we quote the reasoning of Judge Raum's opinion (at pp. 357-358):

> "We agree with petitioner's contention that the phrase 'to which such loss may be carried' modifies 'taxable income' as well as 'each of the prior taxable years.' We further hold that 'taxable income' in this context (as modified by the above phrase) means that taxable income to which the loss is actually applied in computing actual tax liability. . . . We think it is to exalt form over substance to contend that, since a 'regular' computation was made in order to determine whether the amount of tax resulting therefrom was greater than that produced by the 'alternative' method of computation, and since the net operating loss was deducted in full in the 'regular' method, the entire loss was therefore taken into account in the tax computation, even though the 'alternative' method, to which only $1,115.57 was applied, ultimately produced petitioner's actual tax liability."

And the First Circuit found the reasoning of Judge Raum to be so persuasive that it affirmed *per curiam*. Accepting the *Weil* principle that the tax on the capital gain was not reduced by the NOL, it also concluded,

with the Tax Court, that the unused NOL should be carried forward, saying (428 F.2d 474 at p. 475): "It does not seem inappropriate to place a floor at the alternate tax, leaving unused losses to their carryover utility" and that §172(b)(2) "means that taxable income to which the loss is actually applied in computing actual tax liability."

We contend, as was held by the Tax Court, by the court below, by all other district courts and two other Courts of Appeals,[3] that the preferable interpretation is that the phrase, repeated twice in §172(b)(2), "to which such loss may be carried," manifests a congressional intent that a loss would still be available as a deduction, and has not been "carried" to an earlier taxable year, when it has not diminished the taxable income subject to tax or reduced the tax burden of such earlier tax year. If Congress had intended that a mere abstract reduction in the statutory concept of taxable income for one year, as that term is defined by §63(a), not accompanied by any reduction in the tax burden of that year, was sufficient to deprive the taxpayer of the use of the loss to reduce its tax burden in another

[3]The statutory interpretation decided by the Tax Court, and affirmed by the First Circuit, in *Chartier* has since been followed by the Ninth Circuit in two cases, by the Eighth Circuit in the *Foster Lumber* case, by all District Courts which have passed on the issue, and by the Tax Court in subsequent decisions: *Olympic Foundry Co. v. United States,* 493 F.2d 1247 (9th Cir. 1974); *Data Products Corp. v. United States,* aff'd. December 27, 1974 by the Ninth Circuit in an unpublished opinion, No. 74-3341 (pending in this Court on a petition for certiorari filed by the United States (No. 74-996)); *Naegele v. United States,* decided August 6, 1973 (D. Minn.), pending on appeal in the Eighth Circuit No. 73-1921; *Continental Equities Inc. v. Commissioner,* 33 T.C.M. 812 (1974), pending on appeal in the Fifth Circuit; *Mutual Assurance Society of Virginia Corp. v. Commissioner,* 32 T.C.M. 839 (1973), reversed, 505 F.2d 128 (4th Cir. 1975). *Olympic, Data* and *Foster* involved affirmances of three different United States District Courts.

year, it would have used explicit statutory language to say so.

The statute, as construed by the court below and by all the other courts which have followed *Chartier,* simply means that an NOL has been "carried" to a year when it reduces the taxable income on which the ultimate tax is calculated and results in lowering the tax. Conversely, if the NOL merely reduces taxable income, but does not reduce the taxable income on which the tax is computed (as is true under *Weil* where there are capital gains subject to the alternative tax), the loss has not been "carried" to the taxable income of that year.

3. The government's contention, made at considerable length (Br. pp. 17-28) to the effect that "taxable income" in §172(b)(2) means taxable income as defined in §63(a), including capital gains, is a proposition with which we agree. But since none of the courts, including the court below, disagreed, the government's lengthy discussion should not succeed in raising a false issue and in distracting attention from the real question whether an NOL has been "carried" to the taxable income of a particular year if it does not diminish the taxable income of that year on which the tax is computed. Contrary to what the government claims, the quotation from *Chartier, supra,* p. 17, shows quite plainly that the Tax Court did not find that the bare words "taxable income" in §172(b)(2) had a different meaning than they have in §63(a); rather, it was the "carried" language of §172(b)(2) that proved to that court the congressional intent to have the statute operate in, what we contend, is the appropriate manner. Nor did any of the other courts which have followed

Chartier interpret "taxable income" in §172(b)(2) differently than its §63(a) definition.

4. Still staying with the statutory language and before we turn to other aids to construing the statute, we should take note of the government's assertion that the Tax Court's construction of §172(b)(2) is contrary to the "usage of the Code," in that losses are "deducted" from, not "carried" to, taxable income, and that the term "carried" as used in §172(b)(2) has (Br. p. 26): "the temporal connotation of a transfer of a loss from the year in which it occurred, and would normally be taken into account, to another year." This argument is offered to rebut the Tax Court's view that the phrase "to which such loss may be carried" in the second sentence of §172(b)(2) modifies "taxable income" as well as "prior taxable years." But "carried' is often used in a nontemporal sense. For example:

> "2. To transfer from one place (as a country, book, or column) to another: as . . . to *carry* a number in adding." (Webster's New International Dictionary of the English Language, 2d ed., Definition of "carry.")

Every schoolchild learns to record the results of adding 5 and 7, for example, by reciting "5 and 7 are 12; put down the two; and *carry* the one." To take an example that is closer to home, the final sentence of §1212(a)(1), dealing with the carryback of net capital losses, clearly uses the terms "cannot be carried back in full" and "the amount of such loss which can be carried back" in a numerical sense, referring to amounts that either can, or cannot, be deducted when carried to the earlier year. This provision—the Code's closest statutory analogy to §172—rebuts the government's assertion that "carry" is used in the Code only in a "temporal" sense and that it does not embrace the concept of a deduction.[4]

C. The Decision Below Is Consistent With the Basic Policy of Section 172 to "Average" the Tax Burden by Reducing the Harsh Consequences of the Annual Accounting Period.

1. As is obvious, the fundamental congressional policy for providing a net operating loss deduction comes from the recognition that, in certain circumstances, an annual accounting system for measuring the ability to pay an income tax works too harshly and requires modification.[5] The purpose of the net operating loss provisions has been to arrive at a fair measure of the tax burden by measuring profits during the nine year statutory time span, rather than on a year by year basis, and to achieve some parity between the business whose earnings (measured year by year) are volatile and those whose profits are earned more evenly. As this Court stated in *Libson Shops, Inc. v. Koehler,* 353 U.S. 382, 386 (1957):

> "These provisions were enacted to ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. They were designed to permit a taxpayer to setoff its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year."

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[4]See also Rev. Rul. 66-91, 1966-1 C.B. 54, which uses "carry" in a nontemporal sense, as pointed out *infra,* pp. 42-43.

[5]There are other instances where Congress has mitigated the harshness which would result from a rigid adherence to an annual accounting period system. They include: the investment credit carryover (Section 46(b)); the charitable contribution

(This footnote is continued on next page)

In the words of *Reo Motors, Inc. v. Commissioner*, 338 U.S. 442, 449 (1950), the purpose was ". . . to equalize tax burdens." And the court below also correctly described the congressional policy when it said (500 F.2d at 1232):

> "The basic purpose behind the net operating loss carryback provisions of section 172 is to ameliorate the harsh tax consequences that can result from the necessity of accounting for certain exceptional economic events within the confines of an arbitrary accounting period."

The foregoing summary by the courts of the overall congressional purpose finds support, not only in what the statute does, but in what Congress has repeatedly explained as its policy objective. Thus, after being absent during the worst of the depression years when there was an urgent need for revenue, provisions for the net operating loss deduction (which had originated in 1918) were reintroduced in the Revenue Act of 1939[6] (Act of June 29, 1939, c. 247, §211, 53 Stat. 862) (§§23(s) and 122 of the Internal Revenue Code of 1939, as amended); the fundamental policy was well explained by the House Ways and Means Committee in connection with the 1939 Act as follows (H. R. Rep.

deduction carryover (Section 170(d)); the taxation of lump sum distributions from qualified plans (Section 402(e)); the installment method of reporting gain (Section 453); deferral of income from pre-paid subscription income and pre-paid membership dues (Sections 455 and 456); consent dividends (Section 565); foreign tax credit carryover (Section 904(d) and (e)); capital loss carryover (Section 1212); income averaging (Section 1301); and computation of tax when income, received under claim of right, is later repaid (Sections 1341 and 1342).

[6]The 1938 Act had granted a limited credit for certain purposes so that the results of a loss year could be reflected in the following year.

No. 855, 76th Cong., 1st Sess. (1939-2 C.B. pp. 504, 510-511)):

> "2. Net loss carry-over.—The bill, together with committee amendments, permits taxpayers to carry over net operating business losses for a period of two years. Prior to the Revenue Act of 1932, such 2-year carry-over was allowed. No net loss has ever been allowed for a greater period than two years. In the Revenue Act of 1932, the 2-year net loss carry-over was reduced to one year and in the National Industrial Recovery Act the net loss carry-over was entirely eliminated. As a result of the elimination of this carry-over, a business with alternating profit and loss is required to pay higher taxes over a period of years than a business with stable profits, although the average income of the two firms is equal. New enterprises and the capital goods industries are especially subject to wide fluctuations in earnings. It is, therefore, believed that the allowance of a net operating business loss carry-over will greatly aid business and stimulate new enterprises. . . . An example will show the necessity for such a provision.
>
> Suppose a corporation, over the 3-year period 1939-41, shows the following:
>
> Net operating loss for 1939 .....$2,000,000
> Normal-tax net income for 1940 1,000,000
> Normal-tax net income for 1941 1,000,000
>
> Looking at this 3-year period, it will be seen that the corporation has not made any profit. However, assuming a flat rate of 18 per cent, it would be required to pay a tax of $360,000 if

there were no provision for a net loss carry-over. Under the bill, a corporation in such a case would not be required to pay an income tax."

It will not be overlooked that Congress was concerned with the *taxes* which a business would pay, an objective emphasized in *Libson Shops* and *Reo Motors, supra,* not just a definition of net income which has no effect on the tax cost. And it was also concerned with the economic effect on competitors, desiring to place them in a comparable position so far as *ultimate taxes* paid are concerned, not merely in a comparable definitional status.

The beneficent purposes of the net operating loss deduction were further explained by an influential 1947 report, prepared jointly by the staffs of the Treasury Department and the Joint Committee on Internal Revenue Taxation, from which we quote a pertinent portion:

"A. EQUITY CONSIDERATIONS

In the absence of the loss offsets, the business entity whose net income becomes negative in some periods is not permitted to deduct all the expenses of earning income. To this extent, the tax on net income becomes a tax on capital. The owners of such a firm are discriminated against, because higher taxes are levied on their net income than on the income of owners of businesses with stable income.

B. ECONOMIC CONSIDERATIONS

1. *To remove impediments to risk-taking*

Without loss offsets, investments in assets with less risk of loss are favored over those in which

the risk may be greater. Thus, the absence of loss offsets will reduce the relative investment in risky assets and ventures. Investment in such assets and ventures may be particularly desirable in the economy. Ventures may be risky because they are new firms challenging established ones or introducing new products. If successful, they may bring reduced prices in the industry they enter, or may create employment in an entirely new industry. They may be faced with a period of hard sledding and losses in their early years. If losses in this period cannot be offset against income of future periods, the prospective return from the investment is reduced relative to the return connected with a safer haven for their funds.

2. *To increase the countercyclical effect of taxes*

Absence of loss offsets may also contribute to cyclical instability. In years of losses, expenditures will be held to a minimum. The making of these expenditures may be unprofitable when the firm bears their full cost but must pay a tax on the additional income they would bring in. Yet they might profitably be made if the cost of the expenditure could reduce taxes through loss offsets."[7]

Plainly, the government's "absorption without tax benefit" approach flies in the teeth of these policy objectives of Congress.

2. The problem presented in this case of the relationship between the "averaging" policy of Congress and the taxation of capital gains could not have

[7]Business-Loss Offsets, Hearings on Proposed Revisions of the Internal Revenue Code, Part 5, p. 3784 (1947), in House Committee on Ways and Means, 80th Cong., 1st Sess.

arisen until 1942, when corporate capital gains first became subject to a flat rate of tax. Before 1942, an operating loss of a corporation would always have reduced the tax on both business income and capital gains.

What is important is that, when the alternative tax on long-term capital gains for corporations was instituted by the Revenue Act of 1942, c. 619, §150, 56 Stat. 798, Congress simultaneously amended the net operating loss provisions. We deem it significant that, despite the extensive discussion of the changes made in both parts of the statute, *there is not one word* in the committee discussions to indicate that a carryback would then become meaningless from the viewpoint of the taxes actually imposed on a corporation (and meaningful only in computing revised taxable income on a work sheet) if the carryback was to a year in which the new alternative tax was required to be used, so that the carryback would reduce how net income was calculated, but not the ultimate tax to be paid.

Since Congress was concerned with alleviating the tax burden which would otherwise be arbitrarily imposed by a slavish adherence to a pure annual accounting system, and since this goal could not be achieved merely by reducing what is defined as net income, without diminishing the tax cost, we believe that Congress, had it intended what is being urged by the government, would have explained why it had chosen such a legislative approach or would have made it clear that it tempered its objective, if capital gains were involved in a

carryback or carryover year. Its failure to speak is, we submit, more consonant with the conclusion that it never thought that it was acting in such a non-meaningful manner.[8]

The subsequent legislative history is also eloquent. Thus, while the Revenue Act of 1950, c. 994, 64 Stat. 906, and the Revenue Act of 1951, c. 521, 65 Stat. 452, each made changes both in the net operating loss and the capital gain provisions, and the Technical Changes Act of 1953, c. 512, 67 Stat. 615, again amended the net operating loss provisions, there is not one word of explanation in connection with these three enactments to lend support to the strange interpretation now being urged by the government.[9]

The legislative history is persuasive in still other respects. By the enactment of the Internal Revenue Code of 1954, Congress took a giant step in revising some of the major provisions of the entire tax structure; it also attempted to clarify the language of the statute. The Committee Reports accompanying the 1954 Code contain an extensive explanation of what *substantive* changes Congress was making in the taxing statute.

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[8]See H. R. Rep. No. 2333, 77th Cong., 1st Sess. (1942-2 C.B. 372, 399, 443-444); S. Rep. No. 1631, 77th Cong., 2nd Sess. (1942-2 C.B. 504, 556, 596-597).

[9]See Revenue Act of 1950—H. R. Rep. No. 2319, 81st Cong., 2nd Sess. (1950-2 C. B. 380, 424-425, 445-449); S. Rep. No. 2375, 81st Cong., 1st Sess. (1950-2 C.B. 483, 515-517, 523-524, 543-546).

Revenue Act of 1951—H. R. Rep. No. 586, 82nd Cong., 1st Sess. (1951-2 C.B. 357, 440-442); S. Rep. No. 781, 82nd Cong., 1st Sess. (1951-2 C.B. 458, 481, 498-499, 572-574). See also the

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The 1954 Code made some changes of substance in the net operating loss provisions, which were discussed in the Committee Reports. And, the clarifying language "to which such loss may be carried" had its origin in the 1954 Code.[10] Significantly in using this language, Congress did not indicate that an NOL would achieve no tax reduction where capital gains subject to the alternative computation were involved in a carry year. Moreover, such words as were used tend to indicate it had the opposite thought in mind. For example, in lengthening the carryback period from one to two years, it explained that this not only resulted in an eight year period "for absorbing a loss" but, by increasing the carryback period (and the opportunity for an immediate refund) the statute would "increase the liquid funds for a business experiencing economic reversals".[11] If the government's views are correct, and

discussion of the Joint Committee Staff, accompanying the Revenue Act of 1951 (see 1951-2 C.B. 287, 314-315).

Technical Changes Act of 1953—H. R. Rep. No. 894, 83rd Cong., 1st Sess. (1953-2 C.B. 508, 519-520); S. Rep. No. 685, 83rd Cong., 1st Sess. (1953-2 C.B. 526, 529-530).

[10]See H. R. Rep. No. 1337, 83rd Cong., 2nd Sess. 27 (1954); S. Rep. No. 1622, 83rd Cong., 2nd Sess. 31 (1954), H. R. Conf. Rep. No. 2543, 83rd Cong., 2nd Sess. 30 (1954).

[11]Several significant observations can be made regarding Treasury Regulations 111, §29.122-1, as amended by T.D. 5963, December 16, 1952, issued under the Internal Revenue Code of 1939, as amended. It provided that: "The amount of the net operating loss which may be carried back or carried over to any taxable year is the net operating loss to the extent it was not absorbed by the net income for the other taxable years, preceding such taxable year, to which it was carried back or carried over."

First, the word "absorbed" is not a term appearing in either the 1939 or 1954 Code. As used in the Regulations, however, it conveys the impression that an NOL has not been "absorbed" in another year if it does not reduce the income of such year subject to tax. Secondly, like the current Regulations, which also sometimes uses the word "absorbed," no example is given where

if there were prior capital gains, there could be no increase in liquid funds.

Finally, despite changes made by the Technical Amendments Act of 1958, Public Law 85-866, 72 Stat. 1606, in the net operating loss deduction, and by the Tax Reform Act of 1969, Public Law 91-172, 83 Stat. 487, which dealt both with the capital gains provisions as well as the net operating loss provisions, the Committee Reports do not contain any discussion of this point.

It should be emphasized that the Tax Reform Act of 1969 was enacted after *Chartier* was decided by the Tax Court. If Congress had disagreed with its result, it might be expected to have expressed its disapproval, particularly since the legislation there dealt not only with the net operating loss deduction but also with capital gains and capital losses.[12] Indeed, as we shall

capital gains are subject to the alternative tax, and where (on the government's present theory) the NOL would be "absorbed" even though it produced no reduction in tax. Congress would certainly have been led by these provisions of the Regulations to believe that the statute was being administered in such a way that, within the statutory period, an NOL would be reduced only if it had reduced the taxpayer's actual tax liability. Thirdly, the "carried" language of §172(b)(2) of the 1954 Code may have found its origin in the prior Regulations. But, no matter what its source, it helps to clarify the point that there could be no "absorption" without tax reduction.

It will be noted that the government's brief also uses the term "absorbed" (it also employs the term "used" interchangeably), but in exactly the opposite sense—namely, to mean a reduction in "taxable income" but with no accompanying reduction in tax. As our entire brief demonstrates, the government can point to nothing supporting the strained meaning which it puts on these words and, as used by it in this opposite manner, the words confuse rather than clarify the ultimate issue.

[12]See: Technical Amendments Act of 1958—H. R. Rep. No. 775, 85th Cong., 1st Sess. (1958-3 C.B. 811, 822); S. Rep. No. 1983, 85th Cong., 2nd Sess. (1958-3 C.B. 922, 944-945,

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also discuss under point I-E, *infra*, pp. 38-41, the carryback of capital loss provisions of the 1969 Act are actually incompatible with the interpretation of §172 urged by the government. Consequently, the failure of Congress to reject *Chartier* is further indication of why the court below was correct.

While the legislative history does not, on its face, provide an express answer to the issue here, the absence of any discussion during the many opportunities which Congress had is significant. The silence of Congress, when one would have expected an explanation of a result which would only affect abstract computations on a work sheet, but not the ultimate tax cost, is persuasive that no purely mechanistic result was contemplated.

3. In the light of these consequences of the government's theory, it is not surprising—though it remains noteworthy—that the government's brief makes no serious attempt to reconcile its interpretation of §172(b)(2) with the announced objectives of the legislation. Its assiduous silence is broken only once, by a reference (Br. pp. 29-30) to a 1939 report of the House Committee on Ways and Means, which is described as embodying "the congressional understanding that absent a pre-existing carryback or carryover, no net operating loss deduction can be carried from a year in which the taxpayer does not suffer a loss." According to the government, this "congressional understanding" precludes carrying any part of the taxpayer's 1968

1052-1053); H. R. Conf. Rep. No. 2632, 85th Cong., 2nd Sess. (1958-3 C.B. 1188, 1207).

Tax Reform Act of 1969—H. R. Rep. No. 91-413, 91st Cong., 1st Sess. (1969-3 C.B. 200, 284-285, 290-293, 402-404); S. Rep. No. 91-552, 91st Cong., 1st Sess. (1969-3 C.B. 423, 544, 546-547); H. R. Conf. Rep. No. 91-782, 91st Cong., 1st Sess. (1969-3 C.B. 644, 667-668).

NOL from 1966 to 1967 because "it did not suffer a loss for 1966."

The congressional statement, which is merely cited, but not quoted by the government, in support of this argument, actually reads as follows:

> "The net operating loss deduction is the net operating loss carryover reduced by certain adjustments intended to prevent net losses from being used as a deduction by the taxpayer where he is not suffering any economic loss by reason of the fact that his income contains nontaxable items (as in the case of percentage depletion, exempt interest on State and local bonds, and, with respect to corporations, intercorporate dividends, and interest on partially exempt federal obligations)."[13]

The point to be made about this statement is that it describes, not the provisions of the 1954 Code, but a statutory scheme that was abandoned in 1954;[14] for the years before the Court, an NOL could be carried to and used in a year in which the taxpayer's income contained any of the items mentioned in the quoted statement. Secondly, even if the statement had continued validity, rather than describing obsolete history, it is concerned entirely with the taxpayer who "is not suffering any economic loss *by reason of the fact that his income contains nontaxable items.*" (Emphasis added.)

[13]Detailed Discussion of Certain Technical Provisions of the Revenue Bill of 1939. H. R. Rep. No. 855, 76th Cong., 1st Sess. (1939-2 C.B. 504, 517).

[14]See, for example, S. Rep. No. 1983. 85th Cong., 2nd Sess., pp. 944-945, which recognized that the 1954 Code had departed from the previous economic income concept, so that taxpayers with losses would have the same deductions as taxpayers "with more stable incomes" and that the 1954 Code provisions were more "generous" than before.

Because the alternative tax applied to the taxpayer before the Court, its 1966 long-term capital gains qualified for a reduced rate of tax, but the full amount of the gains was subject to tax; the gains were not in any sense "nontaxable items," and hence would not have been within the ambit of the cited committee report even in the years to which it refers.

If the government's research has discovered firmer support in the legislative history for its interpretation of §172(b)(2), and not merely this flimsy reed, it is not mentioned in the government's brief. In our view, the court below rightly concluded that the basic policy considerations leading Congress to enact §172, which we have summarized above, "decisively" support the interpretation of §172(b)(2) adopted by the court below and, earlier, by the Tax Court in the *Chartier* case.

D. Under the Government's Statutory Interpretation—Which Results in a Tax Deduction Without a Tax Benefit—Accidents of Timing Are Crucial, Although Section 172 Was Enacted to Reduce the Importance of Timing.

1. As shown by Table B, *supra,* p. 11, the government's interpretation of the second sentence of §172(b)(2), if accepted, would tax the taxpayer before the Court on $35,000 more than its economic gain. While this is objectionable in itself and inconsistent with a remedial statute "designed to permit a taxpayer to set off its lean years against its lush years" (*Libson Shops, supra,* p. 21), it is made even more offensive by the capricious nature of the tax burden imposed on the taxpayer. This is so because the government's construction, which results in "absorption" without a reduction in tax, only comes into play if the capital gain in the carry years *precedes* a profit year; if the capital gain

is *concurrent with* or *follows* a profit year, the "absorption" does result in a reduction in tax. Thus, under the government's theory, taxpayers whose circumstances are identical with the taxpayer at bar, save for additional accidents of timing, would either escape its fate or be even worse off.

Thus, a competitor who happened to incur the same 1966 and 1967 business transactions as the taxpayer but in the reverse annual order (but with no change in the time when capital gains were realized), would be able to use its $42,000 of 1968 NOL in full against its business income, and thus would be taxed on $35,000 less than the government seeks to tax to the taxpayer before the Court. This phenomenon, which can hardly be disputed by the government, is illustrated by Table C.

TABLE C

Amounts Taxed if 1966 and 1967 Business Transactions Were Reversed

	— Before Carryback —			—After Carryback —		
Year	Ordinary Income	Long-Term Capital Gain	Total	Ordinary Income	Long-Term Capital Gain	Total
1966	$114,000	$167,000	$281,000	$72,000	$167,000	$239,000
1967	7,000	115,000	122,000	7,000	115,000	122,000
1968	(42,000)	— 0 —	(42,000)	— 0 —	— 0 —	— 0 —
Total	$ 79,000	$282,000	$361,000	$79,000	$282,000	$361,000

A second competitor, who happened to receive in 1966 the business income that the taxpayer before the Court realized in the period 1966-1967, but whose capital gain transactions were also identical with the taxpayer, would also be able to take full advantage of its 1968 NOL. This set of circumstances is illustrated by Table D.

TABLE D

Amounts Taxed if 1966 and 1967 Business Income Were Received in 1966

	— Before Carryback —			— After Carryback —		
Year	Ordinary Income	Long-Term Capital Gain	Total	Ordinary Income	Long-Term Capital Gain	Total
1966	$121,000	$167,000	$288,000	$79,000	$167,000	$246,000
1967	—0—	115,000	115,000	—0—	115,000	115,000
1968	(42,000)	—0—	(42,000)	—0—	—0—	—0—
Total	$ 79,000	$282,000	$361,000	$79,000	$282,000	$361,000

A third competitor who happened to combine into a single year (either 1966 or 1967) both the business income and capital gains that were divided between 1966 and 1967 by the taxpayer before the Court, would also get full advantage of the 1968 NOL. This is shown by Table E.

TABLE E

Amounts Taxed if 1966 and 1967 Were Combined in 1966[15]

	— Before Carryback —			— After Carryback —		
Year	Ordinary Income	Long-Term Capital Gain	Total	Ordinary Income	Long-Term Capital Gain	Total
1966	$121,000	$282,000	$403,000	$79,000	$282,000	$361,000
1967	—0—	—0—	—0—	—0—	—0—	—0—
1968	(42,000)	—0—	(42,000)	—0—	—0—	—0—
Total	$ 79,000	$282,000	$361,000	$79,000	$282,000	$361,000

Still another bizarre result of the happenstance of timing is illustrated by Table F, which assumes a competitor with the same capital gains as were realized by Foster Lumber Co., but which realized in 1967 the business income that Foster Lumber Co. realized in

[15]Dollar totals would be unchanged if 1966 and 1967 transactions occurred in 1967, rather than in 1966.

1966 and 1967. This hypothetical competitor would —under the government's theory—derive no tax benefit from its 1968 NOL (not even the $7,000 which benefited Foster Lumber Co.). Hence, it would be even worse off than the taxpayer before the Court, being overtaxed on income in the amount of $42,000.

TABLE F

Amounts Taxed Under Government's Theory if 1966 and 1967 Business Income Were Received in 1967

	— Before Carryback —			— After Carryback —		
Year	Ordinary Income	Long-Term Capital Gain	Total	Ordinary Income	Long-Term Capital Gain	Total
1966	—0—	$167,000	$167,000	—0—	$167,000	$167,000
1967	$121,000	115,000	236,000	$121,000	115,000	236,000
1968	(42,000)	—0—	(42,000)	—0—	—0—	—0—
Total	$ 79,000	$282,000	$361,000	$121,000	$282,000	$403,000

Finally, we ask the Court's indulgence while we offer one more computation, to illustrate what might be termed the normal taxpayer, which realizes its business income in equal installments over a 3-year period. Since §172 is designed to put taxpayers with fluctuating income on a plane of relative equality with those having a stable source of income, this "normal" taxpayer is an appropriate standard against which to measure the two competing interpretations of §172(b)(2) that are before the Court.

TABLE G

Business Income Realized in Equal Annual Installments

Year	Ordinary Income	Long-Term Capital Gain	Total
1966	$26,333	$167,000	$193,333
1967	26,333	115,000	141,333
1968	26,334	—0—	26,334
Total	$79,000	$282,000	$361,000

The tax results for this "normal" taxpayer conform to the results achieved for all of the taxpayers illustrated by Tables A through F, when the net operating loss deduction is computed in accordance with the decision below. If the government's interpretation of §172 (b)(2) is accepted, however, the caprice of timing will determine which taxpayers qualify for the "normal" pattern and which ones, instead, are taxed on more than their economic gain.

2. Because it is so dependent on accidents of timing, the government's construction of §172(b)(2) has a freakish effect whenever Congress increases the carryback period for net operating losses, as it has done on several occasions. The problem can be illustrated by reference to Table A. If the statutory carryback period had been limited to one year (as was the case, for example, from 1951 to 1954), the taxpayer before the Court would have been able to use its 1968 NOL in full against its 1967 business income. The 1968 NOL was useless (under the government's theory) to the extent of $35,000 only because the first year to which it had to be carried was 1966 rather than 1967. Thus, an increase in the carryback period has the perverse effect of worsening the taxpayer's position whenever an alternative tax year is added to the carryback period. This undermines the legislative objective, as set out by the House Committee on Ways and Means when it recommended a lengthened carryback period in 1954:

> "The longer period for averaging will improve the equity of the tax system as between businesses with fluctuating income and those with comparatively stable incomes, and will be particularly helpful to the riskier types of enterprises which encounter marked variations in profitability. The additional year for the carryback also increases the liquid funds available for a business experiencing economic reverses."[16]

Unlike the government's construction of §172(b)(2) the decision of the court below does not have the untoward effect of penalizing taxpayers when there is a statutory increase in the carryback period, so that the NOL has to be carried back to a tax year in which there was capital gain subject to the alternative tax.

Moreover, the government's construction of §172 (b)(2), by attaching such great significance to the order in which ordinary business income and capital gains are realized, would encourage canny taxpayers to adopt countermeasures as a defensive strategy.[17] For example, by postponing the recognition of capital gains, they would be able to increase the possibility of applying an NOL to business income or, conversely, by postponing business expenditures they could increase the likelihood of using business losses against business income.

Both of these tactics would fly in the face of congressional policies to the contrary. A major reason for the reduced rate on capital gain is the congressional desire not to inhibit the disposition of capital assets. Moreover, as we have pointed out (*supra*, pp. 24-25), one of the congressional reasons for enacting the net operating

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[16]H. R. Rep. No. 1337, 83rd Cong., 2nd Sess. 27 (1954).

[17]This is not idle speculation. A leading tax publication has already pointed out the possibility of tax-motivated maneuvers of this type, which would become advisable if this Court adopts the government's theory. Tax Management Memorandum, June 9, 1975.

loss carryback was to encourage taxpayers to make business expenditures when justified by business condition, rather than to postpone such expenditures for tax reasons. Under the decision below, there is no premium on such artificialities.

E. The Decision Below Is Consistent, and the Government's Theory Is Inconsistent, With Section 1212(a), Enacted in 1969 to Permit Corporations to Carry Capital Losses Back for Three Years.

1. When Congress enacted the alternative method of taxing corporations on their long-term gains in 1942, it simultaneously provided that corporate capital losses could be deducted only to the extent of capital gains. See §1211(a). For this reason, corporate capital losses cannot create net operating losses. Until 1969, corporations could carry their unused capital losses forward but not back to years preceding the year of the loss. In 1969, however, Congress for the first time authorized corporations (but not individuals) to carry their capital losses back to the 3 years immediately preceding the loss year. See §1212(a)(1)(A). Whether carried back under this new provision or forward under the older provision, now §1212(a)(1)(B), the loss is treated as a short-term capital loss in the year to which it is carried, and hence it remains subject to §1211(a) and can be used only against capital gains. Since corporate capital gains were subject to a ceiling rate of 25% in the years under consideration (the rate has since been increased) the legislative scheme embodied in §1211(a) and §1212(a)(1) imposes parallel treatment on capital losses by permitting them to be used only against capital gains, and not against business income that would otherwise be taxed at the regular rate.

But if the government's contention in the case at bar were accepted, the 1969 legislation would have had a startling side-effect so that, where there are net operating loss carrybacks, capital losses could be used against business income. This can be illustrated by extending Table A to assume that the taxpayer realized a net capital loss of $167,000 in 1969.

TABLE H

Table A Extended to Include
1969 Capital Loss of $167,000

Year	Ordinary Income	Long-Term Capital Gain	Taxable Income
1966	$ 7,000	$167,000	$174,000
1967	114,000	115,000	229,000
1968	(42,000)	— 0 —	(42,000)
1969	— 0 —	(167,000)	(167,000)
Total	$ 79,000	$115,000	$194,000

As of the end of 1968, according to the theory advanced by the government, the taxpayer's 1968 NOL was already fully exhausted. But if the taxpayer then incurred the 1969 capital loss of $167,000 that is hypothesized in Table H, it would be permitted by §1212(a)(1)(A) to carry the loss back to 1966,[18] where it would wipe out the capital gain of $167,000.

The startling side effect is that, with the elimination of the 1966 capital gain by carryback of the 1969 capital loss, even the government could no longer contend that the 1968 business loss was absorbed by the same 1966 capital gain. As a result, the 1968 busi-

[18]In point of fact, the 1969 legislation was applicable only to capital losses incurred after Dec. 31, 1969, but the principle illustrated above is correct; and it could be made technically applicable by changing the taxable years in Table H from 1966-69 to 1967-70.

ness loss which, under the government's theory, had been already fully "consumed" before 1969, would now turn out to be revived by the 1969 capital loss. The net effect of the 1969 capital loss, therefore, would not only be an elimination of the tax on the 1966 capital gain (as Congress intended); it would also produce a refund of tax on 1967 business income (which was never the intent of Congress). It would do so by, in effect, creating a net operating loss carryback despite §1212(a)(1)(A)(ii), which expressly provides that a capital loss carryback shall not "increase or produce a net operating loss . . . for the taxable year to which it is being carried."

That this bizarre result would follow from the government's approach to §172 is further evidence that its construction falls wide of the congressional intent. The *Chartier* interpretation, on the contrary, leads to the precise results always contemplated by Congress; ordinary business losses are applied against business income of other years; capital losses offset capital gains of other years.

2. The 1969 legislation is instructive in another respect. The second sentence of §1212(a)(1) provides that a corporation's net capital loss shall be carried back to the earliest year to which it may be carried and then prescribes, in language reminiscent of the second sentence of §172(b)(2), the amount of the loss that may be carried to subsequent years. By itself, this sentence suffers from the same ambiguity that afflicts the statutory language before this Court. But the final sentence of §1212(a)(1) resolves the ambiguity in substantially the same way that the court below resolved the ambiguity in §172(b)(2), viz., the loss is reduced only to the extent that it served to reduce gains

subject to tax and hence the taxpayer's tax liability for the earlier year, and the balance is carried forward to the next year.

This explicit language was inserted in §1212(a)(1) by the conference committee, whose report was filed more than six months after the Tax Court's decision in *Chartier*. Not only did the draftsmen of §1212(a)(1) reach the same result as *Chartier* in resolving the same kind of problem, but they simultaneously refrained from amending §172(b)(2) to overrule *Chartier*, even though another part of §172 was amended by the Tax Reform Act of 1969. See §431(b), Public Law 91-172, 83 Stat. 487. These circumstances, as we have stated, pp. 29-30, *supra*, strongly imply legislative satisfaction with the *Chartier* interpretation of §172(b)(2); at a minimum, at a time when the issue was almost certainly fresh and the Internal Revenue Code of 1954 was being extensively revised, it is significant that Congress failed to indicate any disapproval of *Chartier*, either by revising §172(b)(2) or by adopting a different solution to a comparable problem in the computation of net capital loss carrybacks.

F. The Administrative Practice Supports the Decision Below and Is Inconsistent With the Theory Urged Here by the Government.

1. In a controversy of this type, involving a narrow issue of statutory construction that has been litigated only recently (despite the many prior years when the issue must have arisen in tax returns), the government usually invokes long-standing administrative practice in support of its interpretation. There is no claim of such support here, and with good reason. The only insight into administrative practice is to be found in Rev. Rul.

66-91, 1966-1 C.B. 54, which is inconsistent with the government's current reading of §172(b)(2).

That ruling involved a corporation with "taxable income" in 1961, when it was a member of a group filing a consolidated net operating loss. On January 1, 1962, the taxpayer severed its affiliation with its parent and thereafter filed separate income tax returns. Its 1962 and 1963 returns reported taxable income; in 1964, the taxpayer sustained a net operating loss, which it sought to carry back to 1962 and 1963, rather than to 1961. The Internal Revenue Service ruled that the taxpayer was not required to carry its 1964 loss back to 1961 (where it would have been reduced by the taxpayer's taxable income) "since there was no consolidated taxable income for 1961."

Under the reasoning urged here by the government, however, the taxpayer's 1964 net operating loss would have been "consumed," "used," or "absorbed" by its 1961 "taxable income" to the extent thereof. On the other hand, the ruling supports our position that an NOL is to be reduced, under §172(b)(2), only by the "taxable income . . . to which such loss may be carried." The corporation in the ruling had "taxable income" for 1961, but in the absence of any consolidated taxable income for 1961, there was no 1961 amount to which the 1964 loss could be "carried."

The government's brief (p. 26) as we have previously noted, asserts that the term "carried" has only a "temporal connotation" so that an NOL cannot be "carried" to taxable income. But in Rev. Rul. 66-91, the 1964 NOL could readily be "carried," in the temporal sense, to 1961; the basis of the ruling was that there was no income in 1961 to which the loss could

be "carried." Rev. Rul. 66-91 clearly implies that if the group had reported consolidated net income for 1961, the 1964 NOL would have to be "carried" to this amount.[19]

Thus, the only relevant insight into administrative practice supports the construction of §172(b)(2) adopted by the court below, and is correspondingly inconsistent with the position now being urged by the government.

2. Normally, too, the government is able to point to long-standing Treasury Regulations to support its position. As we shall see, this is not the situation here. Indeed, it is significant that the Regulations seem to have carefully avoided speaking to this problem, thus avoiding a declaration which could have been known to Congress and approved by it, prior to the adoption of its present litigating position by the government.

While the government cites (p. 19) several provisions of the Treasury Regulations as in "accord" with its interpretation of the statutory language of §172(b)(2), an examination of their provisions shows this not to be the case. The first of these references, Treas.

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[19]Rev. Rul. 66-91 cannot be distinguished on the theory that the term "taxable income" has a special statutory meaning if the taxpayer is part of a consolidated group. For one thing, "consolidated taxable income" is itself computed by taking into account the "separate taxable income of each member of the group." See Treas. Regs. §1.1502-11(a)(1). Moreover, Treas. Reg. §1.1502-12 specifies in detail how the separate taxable income of each member of the group is to be computed. See also Treas. Regs. §1.1552-1 (determination of earnings and profits of each member of the group is made by reference to its own "taxable income"). Finally, the fact that every member of a consolidated group has its own "taxable income" is acknowledged, as it must be, by Rev. Rul. 66-91 itself, which specifies that the corporation had "taxable income" for 1961.

Regs. §1.172-4(b)(1)(ii), is a loose paraphrase of the second sentence of §172(b)(2); it offers no independent insight into the meaning of the statute. The other references in the government's brief are to Treas. Regs. §1.172-5(a)(1) and (3), which are even less informative. They amplify the statement in Treas. Regs. §1.172-5(a) that:

> "The taxable income for any taxable year . . . which is subtracted from the net operating loss for any other taxable year to determine the portion of such net operating loss which is a carryback or a carryover to a particular taxable year *is computed* with the modifications prescribed in this paragraph." (Emphasis added.)

But, as we pointed out earlier, neither we nor the courts dispute the mode of computing "taxable income," or the applicability of the modifications set out in the Regulations following the quoted statement. The issue before the Court is whether an NOL is to be reduced by the full amount of the "taxable income" (as thus computed), or only by a portion thereof. Nothing in Treas. Regs. §1.172-5(a)(1) or (3) even purports to deal with this issue.

Finally, the examples set out in the Treasury Regulations to illustrate the computation of the net operating loss deduction consistently present cases in which the "regular method" is used in computing tax liability for the years to which the NOL is carried. See Treas. Regs. §1.172-5(a)(3). Not once is there an example where the capital gain is large enough to bring the alternative tax computation into play, and where, under the government's present theory, there would be an NOL which would lead to no tax benefit. We have already

pointed out (fn. 11, pp. 28-29, *supra*) that the Treasury Regulations issued under the 1939 Code also avoided, in the same manner, any illustration of the result now contended for in the litigating position of the government.

Thus, for more than 30 years, the Treasury Regulations have failed to state explicitly the position only recently assumed by the government in litigation.

We should also point out that in the Regulations dealing with the carryback of capital losses and its interplay with §172 (Treas. Reg. §1.1212-1(a), examples 3 through 6) there is a similar, seemingly deliberate, avoidance of any examples involving use of the alternative tax in capital loss carryback years.

Taken together, these portions of the Treasury Regulations fail to support the government's theory in the very places where such support is to be expected, and by their consistent silence, they suggest a lack of faith at the administrative level in the construction now urged on this Court, and a failure to apprise the Congress that such was the view of the Treasury, if it really had such a view, prior to the present attempt to win the point by litigation.

G. The Statute Should Be Interpreted to Have a Substantive Result—Not One Which Is Purely Formalistic.

It is a salutary approach to the Internal Revenue Code to assume that Congress intended to deal with matters of substance, not with mere formalisms. This Court, and the lower courts, have repeated this principle with regularity. The classic case, of course, is *Gregory v. Helvering*, 293 U.S. 465 (1935) where the literal language of the statute would have compelled the conclusion that there was a nontaxable reorgani-

zation; but this Court rejected the contention that Congress intended to legislate in a formalistic manner, saying (p. 470) in language not inappropriate here:

> "To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."

This Court has always proceeded on the assumption that "Taxation is a practical matter . . ." (*Harrison v. Schaffner,* 312 U.S. 579, 582 (1941)) and that the taxing statute should be so approached. And where the overall intent of Congress to reach such a practical result is evident from the entire statutory scheme, the language of a particular section has received a broader interpretation than would follow if its literal language were the only insight into the congressional meaning. *Corn Products Refining Co. v. Commissioner,* 350 U.S. 46 (1956). Such an effort to discern the congressional intent is, of course, not limited by this Court to cases involving the Internal Revenue Code. See *United Housing Foundation Inc. v. Forman* (decided June 17, 1975); *Muniz v. Hoffman* (decided June 24, 1975).

The Tax Court applied these very principles in *Chartier* (52 T.C. at 358) when it rejected the Commissioner's interpretation as one which would "exalt form over substance."

The government approaches the statute with the single view that Congress was only concerned with the abstract definition of "net income." The practical question of how this would affect the tax burden is evidently considered by it to be so unimportant that the government never makes it explicit to this Court that its contentions would not result in a reduction of the tax

cost. We submit that the time honored principles of statutory construction require a different insight into the congressional intent and the conclusion that Congress meant the statute to operate in a meaningful way, not in the purely abstract manner urged by the government.

H. The Government's Contentions, Urged in Support of a Restrictive Interpretation of Section 172, Will Not Survive Analysis.

1. *The government's insistence on "parallel treatment" for the year in which the loss arose and the years to which a net operating loss is carried conflicts with an express, consistent congressional policy of treating these years differently.*

The government places great stress on the fact that, by virtue of §172(c), a net operating loss does not come into existence for a "loss" year if the business loss for that year is offset by capital gains of equal or greater amount. On this fact, which we do not dispute, the government rests the entire second half of its argument (Br. pp. 28-32). Its position is best summed up by the statement that (Br. p. 29): "the result should be the same" whether the capital gain takes place in one of the carry years or in the business loss year itself.

The unarticulated but critical premise on which this argument rests—"parallel treatment" between the years to which net operating losses are carried and the year in which the loss arose—is superficially appealing. It suffers from only one defect, but the defect is a fatal one: the premise has never been adopted by Congress.

The precise contrary is true. The legislative rules governing net operating losses have been altered many times since the ancestor of §172 was enacted in 1918, but one of the few constants in this sea of variables is that the year in which operating losses occur has repeatedly been treated by Congress differently from the years to which the loss is carried. Not only are the statutory provisions too clear and explicit to admit any doubt, but Congress has repeatedly, through its committee reports, made it clear that it intended no parallel treatment.[20]

For example, Code §172(d) lists certain modifications which, under §172(c) are to be made in the loss year to determine the amount, if any, of the net operating loss, but, in applying §172(b)(2), two of those modifications are not to be used.[21]

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[20]That Congress knew precisely that it was distinguishing between, and did not intend parallel treatment of, the loss year and the carry years is illustrated by the lengthy discussion in H. R. Rep. No. 1337, 83rd Cong., 2nd Sess. 27-28 (1954); S. Rep. No. 1622, 83rd Cong., 2nd Sess. 31-32 (1954); and H. R. Conf. Rep. No. 2543, 83rd Cong., 2nd Sess. 30-31 (1954).

[21]The government states or implies, more than once, that the "modifications" listed in §172(d) must be made in computing the taxable income of a year to which an NOL is carried (Br. 27). Though we regret burdening the Court with still more technical details, there is unfortunately no other way to correct this potentially misleading explanation of §172.

First, contrary to the government's assertion, §172(d) "requires" nothing; it simply *lists* certain "modifications." These adjustments are "required" by two other subsections of §172—§172(c), applicable only to the year in which the NOL arises, which has nothing to do with the years to which the NOL is carried; and the third sentence of §172(b)(2) which is concerned only with the amount of an NOL that can be carried from one of the carryback or carryover years to the next such year. There is *no* provision in §172 requiring any of §172(d)'s modifications to be made in the taxable year in which an NOL is used as a deduction.

A concrete example may clarify this complex statutory plan. If the taxpayer has a business loss of $15,000 and partially tax-exempt interest of $10,000 in 1975, its NOL would be only $5,000, because §172(c) requires the §172(d)(5) modification to be made in determining if the taxpayer has incurred an NOL and, if so, its amount. When this modification is made, the 1975 deductions exceed taxable income (as modified) by only $5,000, and this is the amount of the NOL. But if the partially tax-exempt interest had been received in 1972 rather than in 1975, the results would be quite different. The 1975 business loss would then create a $15,000 NOL, which would be carried back to 1972, where it could be deducted in full from taxable income despite the hypothesized 1972 partially tax-exempt interest. If—but only if—the NOL was not fully used in 1972, it would be reduced by the partially tax-exempt interest (by virtue of the third sentence of §172(b)(2)) in determining the amount to be carried to 1973. Thus, if the 1972 business income was $15,000, the NOL would be fully used to reduce this amount to zero (despite the taxpayer's receipt of $10,000 of partially tax-exempt interest in 1972), and there would be no occasion for making the modifications prescribed by the third sentence of §172(b)(2). But if the business income in 1972 had been $4,000, it would be reduced to zero by the 1975 NOL, the third sentence of §172(b)(2) would be brought into play, and only $1,000 of the NOL ($15,000 minus $4,000 and $10,000) would remain to be carried to 1973.

Thus, while §172(d)(6) actually deals with several modifications, we shall limit our discussion to only one of them as being illustrative, namely, the deduction for dividends received by corporations. Code §243(a) allows (with qualifications) a corporation to deduct 85% of dividends received from other corporations. A corporation having a loss year is, under the modification of §172(d)(6), allowed to deduct 100% of the dividends it receives in that year in computing the amount of its loss which it can carry to other years. However, Code §172 does not provide that this modification is to be made in the carryback or carryforward years. Thus, a corporation will have a different overall tax burden if it receives a dividend in the loss year than if it had received the same dividend in one of the carry years.

Again, in the case of an individual, the modifications required by §172(d)(4) are designed to pre-

vent non-business deductions from increasing the net operating loss attributable to a business (we eschew discussing the technical manner the statute follows in reaching this result). But this modification is not required during a carry year. Again, a taxpayer will have a different overall tax burden, depending on whether non-business deductions were incurred in the loss year or in a carry year.

In order not to prolong this discussion, we have put into Appendix B, *infra*, a table summarizing the various differences which the statute has made over the course of time between the computation of the loss year and the carryback or carryover years. The table amply demonstrates, contrary to the simplistic contention of the government, that Congress has never provided parallel treatment for the loss year and the years to which the loss is carried.

When the issue is approached from the undeniable fact the Congress intended differences between the loss year and the carry years, it is plain that the court below violated no settled congressional policy by permitting a deduction in 1967 for part of the 1968 loss, even though an NOL would not have arisen if the taxpayer's loss and capital gain had been sustained in the same year.

Finally, we emphasize that the government's view will *never* achieve its ostensible goal of parallelism: If the profitable year takes place before the capital gain year in the carry period, or even when they coincide, the NOL is deductible; however, if the capital gain is realized in the loss year, there is no NOL. Thus, even its view creates differences between the loss year and the carry years.[22]

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[22]See the discussion in Point I-D, *supra*, pages 32-38.

2. *The government's assertion that corporations would receive "markedly better treatment" than individuals under the decision below is not warranted.*

The government seems to assert that the *Chartier* rule would place corporations in a better position than individuals and, therefore, it contends that the Tax Court and the court below were wrong (Br. pp. 26-28). But the Tax Court, in dealing with an individual taxpayer, actually reached the same result as it previously did in *Chartier*, where a corporation was involved. *Axelrod v. Commissioner*, 32 T.C.M. 885 (1973). It is only because the Sixth Circuit reversed *Axelrod* (507 F.2d 884 (1975)) (erroneously as we shall show) that the government can point to differences where none truly exist.

This Court, of course, does not have a case involving an individual taxpayer before it and need not pass on the correctness of the Sixth Circuit's decision in *Axelrod, supra*. But because the government, assuming the correctness of *Axelrod*, asserts that (Br. p. 27) "an individual who used the alternative tax of Section 1201 (b) would be denied the very net operating loss carryover allowed to a corporation by the decision below," we are required to discuss the matter more at length than we desire, in order to dispel this erroneous suggestion of discrimination.

In charging discrimination, the government and *Axelrod* point to the modification described by §172(d)(2)(B)—the elimination of the deduction of long-

term capital gains for individuals—as justification for their ultimate position.

The short answer is that an individual, when using the alternative tax, *never is required to use the modification of Section 172(d)(2)(B)*. Neither is a corporation. There is not and need not be any difference in result, when the alternative tax is employed, between an individual and a corporation. The conclusion of the government (which cites but never analyzes the statute in this respect) that there is such a difference or that there need be one is demonstrably erroneous.

The provisions for taxing capital gain must first be examined. While Congress, where the alternative tax computation is to be used, ultimately reaches the same result of placing a flat rate of tax on long-term capital gains, whether realized by corporations or by individuals, it achieves this in a more convoluted way for individuals. § 1201(a), in the case of corporations, does it fairly simply; the amount of income subject to the normal tax is "reduced" by the amount of the capital gain, and the capital gain is then taxed at the flat rate of 25% (increased in years after 1969). The ordinary business income is taxed to all corporations alike. The tax on ordinary income plus the flat tax on capital gain are added together, and result in the total tax imposed.

When an individual (and we here pass over some other complexities of the statute) computes the tax under the *regular* method, there is a "deduction from gross income" (a deduction not available to corporations) of 50% of the net capital gain (Code Section 1202), with the result that only one-half of the capital gain is subject to tax under the *regular* method. When the *alternative* tax is applicable to an individual (because it is lesser), Code Section 1201(b) provides

that the normal tax applies to all income, after eliminating all capital gains income; it achieves this result by requiring that income shall "be reduced by 50 percent" of the gain (the other 50% having already been eliminated by the deduction of Section 1202); it then adds a 25% tax on the full amount of the net long-term capital gain to the regular tax on non-capital gain income. The deduction of Code §1202, quite clearly, is only meaningful when the *regular* method is used by individuals; *it has no significance when the alternative tax is used.*

Code §172(d)(2)(B) provides that one of the modifications applicable "to taxpayers other than corporations," is that the deduction afforded by §1202 for long-term capital gains shall not be allowed. But, when the alternative tax is computed for individuals, a flat rate of tax is imposed on the full amount of the capital gain (just as is true for corporations) and the §1202 deduction is not utilized. Therefore, if the alternative tax is applicable in the loss year, or in the carry year, or both, there is no deduction for capital gains in the computation and the §172(d)(2)(B) modification is not applicable. It is only applicable where the regular tax is imposed.

Turning now to the NOL provisions, under the *Chartier* construction of §172(b)(2), neither individuals nor corporations are disadvantaged by being required to reduce an NOL by capital gains that have been taxed in full under the alternative tax, for the NOL is still available as a deduction in other years. §172(d)(2)(B) does not alter this status of equality between individuals and corporations.

There is, therefore, no discrimination against individuals using the alternative tax. The government's

claim to the contrary is based on the erroneous assumption that individuals subject to the alternative tax are required to make a §172(d)(2)(B) adjustment that, in actuality, is applicable only when the regular method of computing tax is employed. It and the Sixth Circuit in *Axelrod, supra,* are plainly wrong in believing that inequality of treatment flows from the decision below.

3. *The government is wrong in contending that the decision below entails an improper "pyramiding" of tax benefits.*

The government asserts (Br. pp. 31-32) that the decision below allows a "pyramiding" of tax benefits. If this means only that the taxpayer was permitted to use two provisions of the Internal Revenue Code, the result is obviously no more objectionable than is a taxpayer's deduction of medical expenses and also of charitable contributions when both deductions are authorized by the Code.

But the pejorative implication of the term "pyramiding" is totally unwarranted. As a quick review of Table B indicates, the decision below results in taxing a total of $361,000 over the period 1966-68, which corresponds to the taxpayer's economic gain for that period. Moreover, the ordinary income component ($79,000) is taxed at the ordinary rate prescribed by Congress for ordinary income, while the long-term capital gain component ($282,000) is taxed at the rate prescribed by Congress for capital gains. The decision below, therefore, entails no improper "pyramiding" of tax benefits, but rather reaches the results intended by Congress.

The government's argument here, moreover, overlooks the plain fact that Congress has made two distinct policy decisions, neither having anything to do with the other directly. The NOL deduction, of course, is designed to iron out fluctuations in income. The alternative tax on capital gains results from complex economic considerations (too involved to be discussed in a few words[23]) respecting the disposition of capital assets. To contend that there is an erroneous "pyramiding" of benefits when both congressional policies are given effect, as they were by the court below, is to contend that only one, but not both of these policies, should be followed by the courts. Such a contention is plainly wrong.

Inadvertently, however, the government has raised a genuine issue. Under its theory, the taxpayer will be taxed on $35,000 more than its economic gain during the period 1966-68. *That,* we submit, is an improper "*pyramiding*" of income subject to tax.

4. *The repeal of the 1924-34 rules regarding computation of the alternative tax does not provide support for the government's construction of Section 172(b)(2).*

The court in the *Mutual Assurance* case, *supra,* thought that it found strong support for its construction of §172(b)(2) in the fact that Congress repealed the 1924-34 rules prescribing the method of computing the alternative tax on capital gains when the taxpayer had an excess of ordinary deductions over ordinary income in the same year. This excursion into ancient history proves nothing. We are not sure whether the government recognizes the defects of the reasoning in the

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[23]See, for example, U.S. Treasury Department, "Federal Income Tax Treatment of Capital Gains and Losses" (1951); Seltzer, "The Nature and Tax Treatment of Capital Gains" (1951).

Mutual Assurance decision; it seems to do so, for it relegates to a footnote a summary of that reasoning without an explicit endorsement. (See Br. p. 31, fn. 19.)

Plainly, the Fourth Circuit was wrongly persuaded by the bit of statutory history on which it relied. Briefly summarized, the 19′ ·34 legislation in question provided that the net operating losses of non-corporate taxpayers (the only ones subject, during those years, to an alternative tax on capital gains) were to be offset against the capital gains subject to the alternative tax. See Revenue Act of 1924, c. 234, §208(a)(5), 43 Stat. 253. From the repeal of this provision, relating to non-corporate taxpayers, for the offset of operating losses against capital gains of the same year when the alternative tax was applicable, the Fourth Circuit concluded (1) that subsequent legislation containing no such explicit direction should be construed to forbid an offset in these circumstances, (2) that when an NOL is carried to an alternative tax year, it should not be offset against the capital gains of that year, and (3) finally, that when the NOL is carried from the capital gain year to the following year, it must be reduced by the capital gains even though it does not affect the alternative tax paid thereon.

The first negative inference in the foregoing chain of reasoning was accepted in the *Weil* case; the second, in the first part of the *Chartier* case. Whether the repeal of the 1924-34 legislation warrants these two negative inferences or not, they are at least closely linked to the 1924-34 rules.

The third negative inference (which is, of course, the issue to be decided by this Court), however, is far removed from the 1924-34 rules, both in time and in

logic. For ought that appears, Congress may have repealed the 1924-34 rules for non-corporate taxpayers (or refrained in later years from reinstating them) in order *to increase* the circumstances in which business losses will be offset against ordinary income, rather than to diminish that possibility. For this reason, quite aside from the numerous other statutory changes that make it perilous to draw conclusions from the repeal of obsolete legislation, the abandonment of the 1924-1934 rules does not provide support for the government's construction of §172(b)(2).

II.

The Tax Court's Construction of Technical Provisions of the Internal Revenue Code, Unless Clearly Erroneous, Should Be Given Great Weight by the Federal Courts of General Jurisdiction.

This case involves nothing more than the proper construction of narrowly technical provisions of the Internal Revenue Code, on which the Tax Court has reached the same conclusion as the court below on four occasions. The issue immediately before the Court is colored by a series of other technical issues, including the proper computation of the alternative tax for the prior year, the relationship between individual taxpayers and corporations, the operation of the capital loss carryback, and even the right of a taxpayer in special circumstances to use the alternative tax method even if it produces a higher tax than the regular method.[24]

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[24]See *Lone Manor Farms, Inc. v. Commissioner*, 61 T.C. 436 (1974), aff'd January 27, 1975 by the Third Circuit in an unpublished opinion, holding that §1201 does not permit the taxpayer to use the "alternative method" when it will produce a higher tax liability than the regular method, even if

(This footnote is continued on next page)

Where complex details of the taxing statute and the minutiae of legislative history must be explored, we submit that the Tax Court, by virtue of its specialized jurisdiction and daily immersion in the Internal Revenue Code and Treasury Regulations, is better situated than the federal courts of general jurisdiction to arrive at a correct conclusion.[25] Decisions like these, important though they are to the parties, do not establish or modify important principles of tax law, nor do they shed any light on other areas of the law. Indeed, one can hardly conjure up a question of less general importance than the one that is now before the Court.

If the Fourth Circuit, in *Mutual Assurance, supra* (a case where so little was involved that the taxpayer did not seek review by this Court) had placed greater

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the taxpayer would thereby preserve a net operating loss for use in another year. The case involves difficult questions under §6214(b) (prescribing the jurisdiction of the Tax Court) and the statute of limitations, as well as under §1201 and §172. For these reasons, the *Lone Manor Farms* case can hardly serve to support the government's position in the case at bar (as suggested by its Brief p. 33, n. 22), unless this Court is prepared to determine the validity of the Tax Court's holding without briefs and arguments on these complex issues. As we urge, however, acceptance of the Tax Court's determination in such technical cases would leave standing the principles established by both *Lone Manor Farms, Inc.* and *Chartier.*

[25]See the comment of Mr. Justice Jackson in *Arrowsmith v. Commissioner,* 344 U.S. 6, 10 (1952) (dissent), regarding the Tax Court's ability to work its way through "a field beset with invisible boomerangs," quoted with seeming approval by Mr. Justice Stewart, in his Remarks at the dedication of the Tax Court's new courthouse, 28 Tax Lawyer 451, 453 (1975).

In the same issue of the publication, in an article which reviews the *Chartier* problem, the conclusion is reached that the *Chartier* line of cases "are more soundly based on the policy underlying the favorable treatment of capital gains" and that the rationale attempted by the Fourth and Sixth Circuits "should not stand in the way of the sound policy of *Chartier* and the cases that have followed it." Branda, *Net Operating Losses and Capital Gains—Some Bizarre Consequences of the Alternative Tax Computation,* 28 Tax Lawyer 455, 470 (1975).

reliance on the expertise of the Tax Court, and had not thought that it had found a new insight into the congressional meaning, the present conflict in decisions would not have arisen and another case would not have been needlessly added to this Court's heavy docket.

We urge that in cases of this character, the Tax Court's construction of technical provisions of the Internal Revenue Code, unless clearly erroneous, should be given great weight by the federal courts of general jurisdiction.[26] In urging this point, we do not suggest that the Tax Court is in any sense better equipped than the other federal courts to decide all tax cases, or that it has a monopoly on judicial wisdom. In many tax cases, the technical issues are subservient to broader legal principles, and are illuminated by the breadth of experience that courts of general jurisdiction gain from their diversified caseloads. But the indispensable contribution of these courts to the resolution of important tax cases is inevitably diluted by the demands of cases that require time-consuming inquiries into technical details that have no significance beyond their own ambit.

III.

If the Decision Below Is Reversed, the Principle Decided in Weil v. Commissioner, as Applied in the Chartier Case, Should Be Rejected.

The court below, and both the government and the taxpayer before this Court, have assumed that in recomputing its 1966 tax liability under the alternative

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[26]This principle would not entail a revival of *Dobson v. Commissioner,* 320 U.S. 489 (1943), or a violation of the "clearly erroneous" rule of §7482(a) of the Internal Revenue Code, enacted in 1948. Our proposal is limited to interpretations of technical provisions of the Internal Revenue Code that are not clearly erroneous.

method, the taxpayer was not permitted to apply its 1968 NOL carryback against its long-term capital gains. As we have pointed out, this construction of §1201(a)(2) originated with *Weil v. Commissioner* and was applied explicitly to corporations with NOL carrybacks in the first part of the *Chartier* case (*supra*, p. 15). When the Tax Court went on in *Chartier* to hold that the NOL had not been reduced by the application of the *Weil* principle and was still available under the "carried" language of §172(b)(2), it obviously (and, we submit, properly) regarded the two issues as interrelated aspects of a single harmonious statutory framework.

If this Court should adopt the construction of §172(b)(2) urged by the government and reverse the court below, we urge the Court to re-examine, and reject, the *Weil* principle. We submit that the only rational basis for accepting the government's construction of §172(b)(2) is that (contrary to the *Weil* principle) the NOL was available in 1966 to reduce the amount of capital gains subject to tax.

The effect of rejecting *Weil* would be that the net loss sustained by business operations, even though not reducing the higher tax on business income during 1967, would at least be available to recoup the 25 percent tax paid on the 1966 capital gains, rather than disappearing altogether. A rejection of the *Weil* principle would also reduce the bizarre consequences of timing that we have illustrated earlier (*supra*, pp. 32-40) by permitting business losses to be applied against both ordinary income and capital gain (a) whether tax liability is computed under the regular or alternative method, (b) whether the capital gains are realized in the same year as the business losses or in a year to which the

losses are carried under §172, and (c) in the latter circumstances, regardless of the chronological order in which the taxpayer happens to realize its ordinary income and capital gains, or even a capital loss.

We frankly admit that the language of §1201(a)(2), standing alone, supports the result reached in *Weil* and applied in *Chartier* (first issue). But if the closely related second issue in *Chartier* is decided as the government here urges, the statutory language of §1201(a)(2) should not be accepted as conclusive, in view of the consequences it would then have. Indeed, the Tax Court might have overruled *Weil* in *Chartier* if it had been convinced that Congress intended the NOL to be absorbed by the capital gains of the prior year in all circumstances.

It should be noted that, in other situations, the Courts of Appeals have refused to apply the plain implications of *Weil*, when convinced that it would lead to a result not contemplated by Congress. Thus, in *Statler Trust v. Commissioner*, 361 F.2d 128 (2d Cir. 1966), the court (District Judge Dooling dissenting), rejected the argument that a trust which had made a capital gain distribution to charities was not entitled to a deduction for such distribution when computing its capital gain tax liability under the alternative method. The Court refused to accept the Commissioner's argument (resting on *Weil*) that a deduction is not permitted to reduce the amount of capital gain subject to the alternative tax. Speaking for the Court, Judge Friendly said (at p. 131):

> "The argument stresses the form at the neglect of substance; the letter of §1201(b) must yield when it would lead to an unfair and unintended result. See Read v. United States, 320 F.2d 550 (5th Cir. 1963)."

After examining the congressional purpose in providing deductions for trust distributions to charity, the court went on to say (p. 132):

> "Thus the literal reading of §1201(b) urged by the Commissioner would not only be inconsistent with the general scheme of trust taxation but would bring about adverse results with respect to charitable gifts that Congress is unlikely to have intended."

The circumstances here are parallel. The net operating loss, if it is to be treated as "absorbed" by the capital gain, should be allowed to reduce that capital gain. Even if the language of the statute, standing alone, suggests a different answer, it ought to yield to the basic legislative purpose of having the net operating loss serve the function of permitting "a taxpayer to set off its lean years against its lush years" (*Libson Shops, Inc. v. Koehler, supra,* p. 21).

Again, in *Read v. United States,* 320 F.2d 550 (5th Cir. 1963), the United States contended that, under the doctrine of *Weil,* a deduction under §691(c) (for federal estate taxes paid on income in respect of a decedent) was not available to reduce the amount of capital gain where the alternate tax computation is used. The Court said (pp. 552-553):

> "The Government argues that since there is no express provision making the deduction applicable in alternative tax computations, it is clear and certain that the deduction cannot be taken. The executrix, with like logic, contends that the deduction is permitted and if it were to be withheld in capital gains taxation the statute would have said so. We profit but little from such reasoning. We do not think it can be said that the language of the statute is of itself decisive of the question.
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> * * *
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> To adopt the Government's view would result in the imposition of both estate and income tax on the income amounts where the alternative computation was used. There is no more reason to suppose that Congress intended such a result than to suppose that it intended that the right to use the deduction in the alternative method of computation in respect of such income should be allowed.
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> * * *
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> The offsetting is a *pro tanto* cancelling out. It works a reduction in the amount of the particular kind of income which is to be subject to taxation. There is equal purpose to be served and a like reason for allowing the deduction where the alternative tax computation is used as where it is not. The decision of the Court is reversed and the proceeding is remanded for a redetermination of the tax under the principle here stated."

In the words of the Fifth Circuit, we submit that there is an "equal purpose" to be served by the net operating loss deduction, whether the taxpayer is subject to the regular or the alternative tax computation in the carryback year. See also *Meissner v. United States,* 364 F.2d 409 (Ct. Cl. 1966), which not only followed *Read,* but went further to hold that §691(c) deductions could be applied against ordinary income as well as capital gains. Agreeing with *Read* that the statute was susceptible of several interpretations so that an inquiry into its legislative purpose was required, the court said (364 F.2d at 414) "allowing [the deduction]

under both steps of the alternative tax computation in a way that is most advantageous to a taxpayer best gives effect to this [legislative] purpose, and the text of the statute is consistent with this approach." Substantially the same point can be made about §1201 (a)(1) if the Court reverses the decision below.

Finally, we recognize that the 1966 capital gain year is not before the Court, so that the application of *Weil* is not a precise issue. But if the decision below is reversed, we suggest that the only plausible reasoning which would lead to such a conclusion would involve a rejection of the *Weil* principle and, in such an event, it would be appropriate that the rejection be made clear in the Court's opinion.

Conclusion.

For all the reasons which have been stated, the decision below should be affirmed. Alternatively, the principle embodied in *Weil v. Commissioner,* 23 T.C. 424, aff'd 229 F.2d 593 (6th Cir. 1956) should be rejected.

Respectfully submitted,

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APPENDIX A.

Statute and Regulations.

Internal Revenue Code of 1954 (26 U.S.C.):

Sec. 11 [as amended by Sec. 121, Revenue Act of 1964, P.L. 88-272, 78 Stat. 19, 25]. Tax Imposed.

(a) *Corporations in General.*—A tax is hereby imposed for each taxable year on the taxable income of every corporation. The tax shall consist of a normal tax computed under subsection (b) and a surtax computed under subsection (c).

(b) *Normal Tax.*—The normal tax is equal to the following percentage of the taxable income:

* * *

(2) 22 percent, in the case of a taxable year beginning after December 31, 1963.

(c) *Surtax.*—The surtax is equal to the following percentage of the amount by which the taxable income exceeds the surtax exemption for the taxable year:

* * *

(3) 26 percent, in the case of a taxable year beginning after December 31, 1964.

(d) *Surtax Exemption.*—For purposes of this subtitle, the surtax exemption for any taxable year is $25,000. * * *

* * *

Sec. 63. Taxable income defined.

(a) *General Rule.*—Except as provided in subsection (b), for purposes of this subtitle the term "taxable income" means gross income, minus the deductions allowed by this chapter, other than

the standard deduction allowed by part IV (sec. 141 and following).

* * *

Sec. 172. Net operating loss deduction.

(a) *Deduction Allowed.*—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

(b) [as amended by Sec. 317(b), Trade Expansion Act of 1962, P.L. 87-794, 76 Stat. 872, 889, and Secs. 210(a) and 210(b), Revenue Act of 1964, P.L. 88-272, 78 Stat. 47-49] *Net Operating Loss Carrybacks and Carryovers.*—

(1) *Years to which loss may be carried.*—

(A)(i) Except as provided in clause (ii) and in subparagraph (D), a net operating loss for any taxable year ending after December 31, 1957, shall be a net operating loss carryback to each of the 3 taxable years preceding the taxable year of such loss.

* * *

(B) Except as provided in subparagraphs (C) and (D), a net operating loss for any taxable year ending after December 31, 1955, shall be a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss.

* * *

(2) *Amount of carrybacks and carryovers.*—Except as provided in subsections (i) and (j),

the entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the "loss year") shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. For purposes of the preceding sentence, the taxable income for any such prior taxable year shall be computed—

(A) with the modifications specified in subsection (d) other than paragraphs (1), (4) and (6) thereof; and

(B) by determining the amount of the net operating loss deduction—

(i) without regard to the net operating loss for the loss year or for any taxable year thereafter, and

(ii) without regard to that portion, if any, of a net operating loss for a taxable year attributable to a foreign expropriation loss, if such portion may not, under paragraph (1)(D), be carried back to such prior taxable year,

and the taxable income so computed shall not be considered to be less than zero. * * *

(c) *Net Operating Loss Defined.*—For purposes of this section, the term "net operating loss" means (for any taxable year ending after December 31, 1953) the excess of the deductions allowed by this chapter over the gross income.

Such excess shall be computed with the modifications specified in subsection (d).

(d) [as amended by §7, P.L. 87-792, 76 Stat. 829] Modifications.—The modifications referred to in this section are as follows:

(1) Net Operating Loss Deduction.—No net operating loss deduction shall be allowed.

(2) Capital Gains and Losses of Taxpayers Other Than Corporations.—In the case of a taxpayer other than a corporation—

(A) the amount deductible on account of losses from sales or exchanges of capital assets shall not exceed the amount includible on account of gains from sales or exchanges of capital assets; and

(B) the deduction for long-term capital gains provided by section 1202 shall not be allowed.

(3) Deduction for Personal Exemptions.—No deduction shall be allowed under section 151 (relating to personal exemptions). No deduction in lieu of any such deduction shall be allowed.

(4) Nonbusiness Deductions of Taxpayers Other Than Corporations.—In the case of a taxpayer other than a corporation, the deductions allowable by this chapter which are not attributable to a taxpayer's trade or business shall be allowed only to the extent of the amount of the gross income not derived from such trade or business. For purposes of the preceding sentence—

(A) any gain or loss from the sale or other disposition of—

(i) property, used in the trade or business, of a character which is subject to the al-

lowance for depreciation provided in section 167, or

(ii) real property used in the trade or business, shall be treated as attributable to the trade or business;

(B) the modifications specified in paragraphs (1), (2)(B), and (3) shall be taken into account;

(C) any deduction allowable under section 165(c)(3) (relating to casualty losses) shall not be taken into account; and

(D) any deduction allowed under section 404 or section 405(c) to the extent attributable to contributions which are made on behalf of an individual who is an employee within the meaning of section 401(c)(1) shall not be treated as attributable to the trade or business of such individual.

(5) Special Deductions for Corporations.—No deduction shall be allowed under section 242 (relating to partially tax-exempt interest) or under section 922 (relating to Western Hemisphere trade corporations).

(6) Computation of Deduction for Dividends Received, etc.—The deductions allowed by sections 243 (relating to dividends received by corporations), 244 (relating to dividends received on certain preferred stock of public utilities), and 245 (relating to dividends received from certain foreign corporations) shall be computed without regard to section 246 (b) (relating to limitation on aggregate amount of deductions); and the deduction allowed by section 247 (relating to dividends

paid on certain preferred stock of public utilities) shall be computed without regard to subsection (a) (1) (B) of such section.

Sec. 1201. Alternative tax.

(a) [as amended by Sec. 8(g)(3), Revenue Act of 1962, P.L. 87-834, 76 Stat. 960, 999] *Corporations.*—If for any taxable year the net long-term capital gain of any corporation exceeds the net short-term capital loss, then, in lieu of the tax imposed by sections 11, 511, 821(a) or (c), and 831(a), there is hereby imposed a tax (if such tax is less than the tax imposed by such sections) which shall consist of the sum of—

(1) a partial tax computed on the taxable income reduced by the amount of such excess, at the rates and in the manner as if this subsection had not been enacted, and

(2) an amount equal to 25 percent of such excess, or, in the case of a taxable year beginning before April 1, 1954, an amount equal to 26 percent of such excess.

In the case of a taxable year beginning before April 1, 1954, the amount under paragraph (2) shall be determined without regard to section 21 (relating to effect of change of tax rates).

(b) *Other taxpayers.* If for any taxable year the net long-term capital gain of any taxpayer (other than a corporation) exceeds the net short-term capital loss, then, in lieu of the tax imposed by sections 1 and 511, there is hereby imposed a tax (if such tax is less than the tax imposed by such sections) which shall consist of the sum of—

(1) a partial tax computed on the taxable income reduced by an amount equal to 50 percent of such excess, at the rate and in the manner as if this subsection had not been enacted, and

(2) an amount equal to 25 percent of the excess of the net long-term capital gain over the net short-term capital loss.

Sec. 1202. Deduction for capital gains.

In the case of a taxpayer other than a corporation if for any taxable year the net long-term capital gain exceeds the net short-term capital loss, 50 percent of the amount of such excess shall be a deduction from gross income. In the case of an estate or trust, the deduction shall be computed by excluding the portion (if any), of the gains for the taxable year from sales or exchanges of capital assets, which, under sections 652 and 662 (relating to inclusions of amounts in gross income of beneficiaries of trusts), is includible by the income beneficiaries as gain derived from the sale or exchange of capital assets.

Sec. 1212. [As Amended by §513, Tax Reform Act of 1969, P.L. 91-172, 83 Stat. 638-642]. Capital Loss Carrybacks and Carryovers.

(a) CORPORATIONS.—

(1) IN GENERAL.—If a corporation has a net capital loss for any taxable year (hereinafter in this paragraph referred to as the "loss year"), the amount thereof shall be—

(A) a capital loss carryback to each of the 3 taxable years preceding the loss year, but only to the extent—

(i) such loss is not attributable to a foreign expropriation capital loss, and

(ii) the carryback of such loss does not increase or produce a net operating loss (as defined in section 172(c)) for the taxable year to which it is being carried back; and

(B) a capital loss carryover to each of the 5 taxable years (10 taxable years to the extent such loss is attributable to a foreign expropriation capital loss) succeeding the loss year,

and shall be treated as a short-term capital loss in each such taxable year. The entire amount of the net capital loss for any taxable year shall be carried to the earliest of the taxable years to which such loss may be carried, and the portion of such loss which shall be carried to each of the other taxable years to which such loss may be carried shall be the excess, if any, of such loss over the total of the net capital gains for each of the prior taxable years to which such loss may be carried. For purposes of the preceding sentence, the net capital gain for any such prior taxable year shall be computed without regard to the net capital loss for the loss year or for any taxable year thereafter. In the case of any net capital loss which cannot be carried back in full to a preceding taxable year by reason of clause (ii) of subparagraph (A), the net capital gain for such prior taxable year shall in no case be treated as greater than the amount of such loss which can be carried back to such preceding taxable year upon the application of such clause (ii).

* * *

(b) OTHER TAXPAYERS.—

(1) In General.—If a taxpayer other than a corporation has a net capital loss for any taxable year—

(A) the excess of the net short-term capital loss over the net long-term capital gain for such year shall be a short-term capital loss in the succeeding taxable year, and

(B) the excess of the net long-term capital loss over the net short-term capital gain for such year shall be a long-term capital loss in the succeeding taxable year.

(2) Special Rules.—

(A) For purposes of determining the excess referred to in paragraph (1)(A), an amount equal to the amount allowed for the taxable year under section 1211(b)(1)(A), (B), or (C) shall be treated as a short-term capital gain in such year.

(B) For purposes of determining the excess referred to in paragraph (1)(B), an amount equal to the sum of—

(i) the amount allowed for the taxable year under section 1211(b)(1)(A), (B), or (C), and

(ii) the excess of the amount described in clause (i) over the net short-term capital loss (determined without regard to this subsection) for such year,

shall be treated as a short-term capital gain in such year.

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.).

§ 1.172-1. Net operating loss deduction—(a) *Allowance of deduction.* Section 172(a) allows as a deduction in computing taxable income for any taxable year subject to the Code the aggregate of the net operating loss carryovers and net operating loss carrybacks to such taxable year. This deduction is referred to as the net operating loss deduction. The net operating loss is the basis for the computation of the net operating loss carryovers and net operating loss carrybacks and ultimately for the net operating loss deduction itself. The net operating loss deduction shall not be disallowed for any taxable year merely because the taxpayer has no income from a trade or business for the taxable year.

(b) *Steps in computation of net operating loss deduction.* The three steps to be taken in the ascertainment of the net operating loss deduction for any taxable year subject to the Code are as follows:

(1) Compute the net operating loss for any preceding or succeeding taxable year from which a net operating loss may be carried over or carried back to such taxable year.

(2) Compute the net operating loss carryovers to such taxable year from such preceding taxable years and the net operating loss carrybacks to such taxable year from such succeeding taxable years.

(3) Add such net operating loss carryovers and carrybacks in order to determine the net operating loss deduction for such taxable year.

* * *

(d) *Ascertainment of deduction dependent upon net operating loss carryback.* If the taxpayer is entitled in computing his net operating loss deduction to a carryback which he is not able to ascertain at the time his return is due, he shall compute the net operating loss deduction on his return without regard to such net operating loss carryback. When the taxpayer ascertains the net operating loss carryback, he may within the applicable period of limitations file a claim for credit or refund of the overpayment, if any, resulting from the failure to compute the net operating loss deduction for the taxable year with the inclusion of such carryback; or he may file an application under the provisions of section 6411 for a tentative carryback adjustment.

(e) *Law applicable to computations*—(1) *General.* The following rules shall apply to all taxable years without regard to whether they began before, on, or after January 1, 1954:

(i) In determining the amount of any net operating loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year.

(ii) The net operating loss for any taxable year shall be determined under the law applicable to that year without regard to the year to which it is to be carried and in which, in effect, it is to be deducted as part of the net operating loss deduction. In applying this rule, however, certain taxable years subject to the Internal Revenue Code of 1939 shall, to the extent provided in paragraphs (a) and (c) of § 1.172-2 and paragraphs (a) and (e) of § 1.172-3, be treated as though subject to the Internal Revenue Code of 1954.

(iii) The amount of the net operating loss deduction which shall be allowed for any taxable year shall be determined under the law applicable to that year.

* * *

§ 1.172-2. Net operating loss in case of a corporation.—(a) *Modification of deductions.* A net operating loss is sustained by a corporation in any taxable year beginning after December 31, 1953, if and to the extent that, for such year, there is an excess of deductions allowed by chapter 1 of the Internal Revenue Code of 1954 over gross income computed thereunder; this rule shall apply even though the loss year is otherwise subject to the Internal Revenue Code of 1939. In determining the excess of deductions over gross income for such purpose—

(1) *Items not deductible.* No deduction shall be allowed under—

(i) Section 172 for the net operating loss deduction,

(ii) Section 242 in respect of partially tax-exempt interest, and

(iii) Section 922 in respect of Western Hemisphere trade corporations;

(2) *Dividends received.* The 85-percent limitation provided by section 246(b) shall not apply to the deductions otherwise allowed under—

(i) Section 243(a) in respect of dividends received from domestic corporations,

(ii) Section 244 in respect of dividends received on preferred stock of public utilities, and

(iii) Section 245 in respect of dividends received from foreign corporations; and

(3) *Dividends paid.* The deduction granted by section 247 in respect of dividends paid on the preferred

stock of public utilities shall be computed without regard to subsection (a)(1)(B) of that section.

§ 1.172-4. Net operating loss carrybacks and net operating loss carryovers.—(a) *General provisions*—(1) *Years to which loss may be carried*—(i) *In general.* In order to compute the net operating loss deduction the taxpayer must first determine the part of any net operating losses for any preceding or succeeding taxable years which are carrybacks or carryovers to the taxable year in issue.

* * *

(3) *Amount of loss to be carried.* The amount which is carried back or carried over to any taxable year is the net operating loss to the extent it was not absorbed in the computation of the taxable (or net) income for other taxable years, preceding such taxable year, to which it may be carried back or carried over. For the purpose of determining the taxable (or net) income for any such preceding taxable year, the various net operating loss carryovers and carrybacks to such taxable year are considered to be applied in reduction of the taxable (or net) income in the order of the taxable years from which such losses are carried over or carried back, beginning with the loss for the earliest taxable year.

* * *

(b) *Portion of net operating loss which is a carryback or a carryover to the taxable year in issue*—(1) *Manner of computation.* (i) A net operating loss shall first be carried to the earliest of the several taxable years for which such loss is allowable as a carryback or a carryover, and shall then be carried to the next earliest of such several taxable years, etc. Except

as provided in § 1.172-11, the entire net operating loss shall be carried back to such earliest year.

(ii) The portion of the loss which shall be carried to any of such several taxable years subsequent to the earliest taxable year is the excess of such net operating loss over the sum of the aggregate of the taxable incomes (computed as provided in § 1.172-5) for all of such several taxable years preceding such subsequent taxable year which are subject to the Internal Revenue Code of 1954 and the aggregate of the net incomes computed as provided in 26 C. F. R. (1939) 39.122-4 (c) (Regulations 118) or in the corresponding section of prior applicable regulations) for all of such preceding taxable years which are subject to the Internal Revenue Code of 1939.

APPENDIX B.

The following adjustments to taxable or net income were required in the year of loss but not in the year of carryback or carryover under the respective Revenue Act sections in effect for the years noted below.

ADJUSTMENTS	1918-1920	1921-1923	1924-1927	1928-1932	1938	1939-1953	1954-1962	1963-Present
Excess of tax exempt interest over non deductible interest expense added back.	§204(a)	§204(a)	§206(a)(5)	§117(a)(5)	§26(c)(2)(B)			
Excess of non business deductions over non business gross income added back.	§204(a)	§204(a)	§206(a)(1)	§117(a)(1)		§122(d)(5)	§172(d)(4)	§172(d)(4)
Corporate dividends received deduction added back.		§204(a)	§206(a)(4)	§117(a)(4)				
Depletion in excess of cost added back.		§204(a)	§206(a)(3)	§117(a)(3)	§26(c)(2)(A)			
Capital loss deduction limited to amount of capital gains.			§206(a)(2)	§117(a)(2)				
Deductions for certain corporate dividends received or paid allowed without limitation.							§172(d)(6)	§172(d)(6)
Qualified retirement plan contributions for owner employee added back.								§172(d)(4)(D)